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THE JOURNAL OF Taxation

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NEW DEVELOPMENTS IN TAX ASPECTS OF

Accounting

EDITED BY CARL M. ESENOFF, CPA, & C. W. LAMDEN, Ph.D., CPA

Interest grows in Lifo for fixed assets as means of offsetting inflation

by **MAURICE E. PELOUBET**

Perhaps the major unsolved problem in tax-accounting is the failure of our present tax rules to permit depreciation deductions at anything like the current value of the assets being used up. Inflation plus taxation based on pre-inflation figures is robbing industry of the means to replace its assets as they wear out. The Lifo inventory method has for some years now substantially solved this problem for inventories. A new system, called "reinvestment depreciation" applies the Lifo principle to fixed assets. We asked Mr. Peloubet, long-time student of Lifo, to explain the new system. He does so here, quoting extensively Fred W. Peel, who testified on the subject before the Ways & Means Committee recently.

IN THE PAST TEN YEARS the decline in the value of the dollar has progressed and inflation has continued. The problem is more serious now than it was ten years ago. With a continuing inflationary creep, which many qualified observers believe is inevitable for some years, the problem will become more and more serious in the future.

The "capital squeeze" gets tighter and tighter. The harried executive has a harder and harder time trying to plan a program of plant renewal—not expansion—just keeping what he has. Yesterday's, or day-before-yesterday's, or the last decade's dollars can't be used. They are gone and he is allowed only the same number of today's less-valuable dollars to pay today's prices for machinery and equipment to take the place of what has become obsolete or has worn out.

Dan Throop Smith, Deputy to the Secretary of the Treasury, said in a recent talk before the New York Society of Security Analysts, "Only if the economic problem of assuring replacement of depreciable assets is sufficiently serious should adjustments to historical costs be undertaken with the difficult alternative problems arising therefrom." The situation seems sufficiently serious when the value of the dollar has been cut in half in twelve years and the decline in value is continuing.

Depreciation is insufficient primarily because the Federal income tax laws and regulations, so far as depreciation is concerned, are based on the demonstrably false assumption that the value of the dollar is the same yesterday, today and forever.

Users of long-lived property subject to depreciation are being penalized and discriminated against by the levy of Federal income taxes at effective rates higher than those authorized by law, resulting, in some cases, in an effective tax of more than 100% of true, current, realizable income.

These propositions need no proof. They are so apparent to the businessman and manufacturer that it is hardly necessary to state them. The practical question is what can be done to relieve or ameliorate the effects of insufficient depreciation.

One remedy which can be ruled out as an immediate, practical solution is the revaluation of all depreciable property and the calculation of depreciation on such a base. It has much theoretical appeal and merit, but there is little practical possibility of its adoption.

Another remedy, a drastic and arbitrary shortening of lives, was proposed by several witnesses at the hearings before the Ways and Means Committee of the House of Representatives held in January and February, 1958. This has the practical merit of falling within the general scope of Federal tax policy to the extent that it does not require revaluation and does not result in the recovery of more dollars than were expended. The somewhat arbitrary choices left to the taxpayer are not, however, in agreement with the general income tax policy of the Government.

Another weakness of this recommendation is that it does very little for the taxpayer about to replace property, say, twenty or twenty-five years old.

The third method, called by those advocating it "reinvestment depreciation," provides for a partial recognition of the deficiency in historical cost depreciation which will have the effect of making an allowance for current-value depreciation in arrears when property is retired and reinvestment is made. This method will leave in the hands of the taxpayer money to make his reinvestment when he must spend it but will not give him more total depreciation, or depreciation base, than he has now.

This method agrees well with the present Federal income tax policy. No change is proposed in the method of arriving at useful or economic lives or in the treatment of salvage value. There is a great deal of room for improvement here, but legislation or administrative action on these questions, however important and necessary, should not be confused with the present attempt to bring about some partial recognition of the declining value of the dollar.

The method proposed will result in a depreciation allowance which will, at the time of the retirement of assets and the reinvestment of an equivalent amount in depreciable property, permit a deduction of the depreciation, on a current basis, which should have been written off over the life of the property.

This is similar in principle to the present provisions under which a homeowner who sells a house at a profit is relieved of any tax on his apparent gain if he reinvests the proceeds in another home.

Fred W. Peel of the firm of Alvord and Alvord gave in his recent testimony

before the Ways and Means Committee a general description of the method:

"Reinvestment depreciation is for all practical purposes "LIFO as applied to long-lived properties. LIFO has for the past two decades been recognized as sound business accounting for business enterprises with inventories and the same principle is equally sound as applied to capital equipment.

"Industry is continually spending money for buildings, machinery and equipment. At the same time industry is continually selling, scrapping, or disposing of the same sort of property when it wears out or when it is no longer economical to operate it. Just as in the LIFO method for inventories, the original property (the investment to be maintained) would be on the books of the enterprise at its original cost. When such facilities are used up and replaced, if the taxpayer merely reinvests enough to "keep even," the properties acquired would be put on the books at this original cost and the additional cost due to the decline in the value of the dollar would be charged off immediately. The effect is to allow depreciation sufficient for the taxpayer to maintain his investment in real terms (not inflated dollars).

"The additional cost in current dollars of reinvesting is simply the difference between the original cost of the property disposed of and the equivalent number of dollars which would have to be reinvested today to buy the same amount of property, as determined by using a price index constructed or chosen by the Government. The basic steps in the reinvestment depreciation proposal are as follows:

"1. To maintain the base investment, the deficiency in depreciation in terms of current dollars is made up (but only when the extent of the deficiency is known).

"2. The measure of the extent of the deficiency is the difference between the cost of the original property and its equivalent in current dollars, determined by applying the Government price index when the property is disposed of.

"3. The deficiency is made up only when the property represented by the original investment is disposed of and the equivalent in current dollars is spent for other property—or reinvested.

"4. The basis for tax purposes of the newly-acquired property is its cost, minus the amount of the reinvestment depreciation allowance deducted—so that total depreciation deductions will never exceed actual dollar cost.

"In determining the amount of the reinvestment depreciation deduction the first step is to determine the cost, in terms of current dollars, of the assets sold or dismantled during the taxable year. To arrive at this figure the original, or historical, cost of such assets which were acquired in a given year in the past is increased or decreased by the percentage change in the appropriate price index between the year of acquisition and the current year—the year in which the assets are sold or dismantled.

"The aggregate of the costs of all of the assets sold or dismantled during the year, converted to current dollars, is the amount of reinvestment to which the taxpayer should be entitled without tax penalty. To the extent of the additions which the taxpayer has previously made to depreciation reserves with respect to the assets sold or dismantled during the year, the taxpayer has already received a deduction in computing taxable income. The amount which the taxpayer realizes as salvage through the sale of the assets is offset against the remaining tax basis in the assets. If the assets are disposed of for salvage in an amount less than their remaining tax basis or if they are dismantled while they still have tax basis remaining, the taxpayer is entitled to a deduction for a loss in this amount. However, the total of the foregoing three amounts will only equal the cost basis of the assets figured in terms of historical dollars in the years the assets were acquired. With rising costs this amount falls short of the total costs, in terms of current dollars, of the assets sold or dismantled. It is this deficiency which is the measure of the proposed reinvestment depreciation deduction.

"The reinvestment depreciation deduction will be limited, however, to the amount by which actual reinvestment during the year exceeds the unadjusted or cost basis. In other words, in order for the taxpayer to obtain a reinvestment depreciation deduction, he must reinvest, in current dollars, an amount greater than the total of the dollar amounts already taken into account in computing taxable income with respect to the assets sold or dismantled—that is, the amounts previously added to depreciation reserves, the recovery on salvage, and the loss on sale or dismantlement. For assets which were acquired in years before the reinvestment depreciation provision becomes operative for the taxpayer the unadjusted basis of the assets sold or dismantled, for purposes of this determination, will be their original historical dollar cost. For assets which are acquired after the reinvestment depreciation provision becomes operative with respect to the taxpayer, their basis for this computation will be their cost reduced by the reinvestment depreciation deduction attributable to their own acquisition.

"The effect of limiting the reinvestment depreciation deduction to the amount by which actual reinvestment in the year exceeds the cost basis of the assets sold or dismantled is to guarantee that the amount of the deduction which will be allowed to compensate for the increased cost of reinvestment represents actual reinvestment.

"The assets to which the proposal applies are tangible, physical assets. It will be limited to the assets which are subject to an allowance for depreciation. To be eligible, assets must be either used in the taxpayer's trade or business or used by him for the production of income. Inventory and items held for sale in the course of the taxpayer's trade or business would not be eligible.

"In order to take account of the fact that reinvestment may not exactly coincide with sale and dismantlement of old assets from year to year, the proposal provides for a two-year carry-forward of the unused, or "unreinvested," deficiency between the original cost of the assets sold or dismantled during a year and the equivalent reinvestment cost in current dollars.

"The following examples illustrate the operation of the reinvestment depreciation proposal.

"Example 1. Suppose that in 1958 a taxpayer dismantles a machine purchased in 1938 for $50,000 and fully depreciated since that time. Assume that the cost index shows an increase in costs of 130% from 1938 to 1958. The taxpayer may elect to deduct in 1958, as a reinvestment depreciation allowance, the cost of tangible, depreciable property purchased in 1958 to the extent that its cost exceeds $50,000 (the original, his-

[Mr. Peloubet, a CPA, is senior partner of the accounting firm of Pogson, Peloubet & Co., New York. He is one of the profession's best-known writers, has served the AICPA and other professional bodies in many capacities, and is one of the world's leading authorities on Lifo.]

torical cost of the property dismantled during the year) but does not exceed $115,000 (230% × $50,000). The maximum deduction taken to place the taxpayer on a current-cost basis in this example is $65,000, or the equivalent of the 130% cost increase.

"Example 2. Suppose that, in Example 1, new investment is only $60,000 in 1958, but that additional investments amounting to $200,000 are made in 1959. In this case the taxpayer will take reinvestment depreciation deductions of $10,000 in 1958 and $55,000 in 1959, the total of $65,000 of deductions for the two years being equal to the 130% price index increase multiplied by the $50,000 original cost."

A draft of a proposed amendment to the Internal Revenue Code, providing for the use of the reinvestment method of depreciation, was presented with this testimony.

It is also proposed to help small business and to eliminate record-keeping by allowing any taxpayer using depreciable property an allowance of $50,000 if the allowance for reinvestment depreciation, as defined in the proposed legislation works out to a smaller amount.

As a condition to the use of this method, a taxpayer who elects the reinvestment depreciation method must include, as ordinary income, any gain on disposal of depreciable property coming under the election.

In order to be of practical value, reinvestment depreciation must be authorized by appropriate legislation. A radical approach, changing the whole structure and philosophy of Federal income taxation, would probably produce no result at the present time, nor would a proposal that would bring about a sharp and uncompensated drop in revenue.

The proposed legislation keeps well within the general frame of reference of Federal income tax philosophy. No changes in depreciation rates or lives are required and the fundamental concept of basis, that no more dollars are to be recovered than were expended, is maintained. The only difference is in the period in which deductions are allowed.

Obviously, if basis is to be maintained as at present, there can be no long-run reduction in taxable income. The short-run reduction may be less than expected.

It is estimated by responsible authorities that depreciation on a current-value basis would exceed present allowances by $3,500,000,000 to $4,000,000,000 per year. Statistical studies of five of the country's most important industries, confirmed by studies of a number of individual taxpayers, indicate that the reinvestment method might recover about half of the deficiency or something in the neighborhood of a $2,000,000,000 reduction in taxable income.

In considering whether the budget can stand such a reduction, the first consideration is that it has sustained five-year amortization to the tune of almost $3,000,000,000 a year and that this will run out in the next year or two.

Furthermore, the additional money spent for plant and equipment, which must be spent under the proposed plan for it to work to the taxpayer's advantage, will stimulate the industries suffering most in the recession, capital goods producers, and this will generate activity and income, the only real sources of revenue, throughout the economy.

We have here a happy combination of justice to the taxpayer, advantage to the economy and no real or permanent loss of tax revenue. ☆

Textile union asks denial of acquired loss carryover unless business is continued

SOUND TAX ADVICE for long-range planning doesn't always depend on a current assessment of the likely position of the IRS and the courts on doubtful matters of law. Sometimes the tax man must be aware of the pressures that may be brought on Congress for changes. The practitioner concerned with the technicalities of the corporate reorganization must give some thought to the way the rules are influencing our economy and who is hurt or helped by them. That the textile industry has been going through a period of mergers and has been suffering substantial losses (and that these two are not unrelated) has long been common knowledge. It may be news that the Textile Workers Union has been studying these phenomena and has urged Congress to make changes in the loss carryover rules to prevent what it sees as damage to its own members and to the industry. At the House Ways and Means Committee hearings in February, Solomon Barkin made an elaborate analysis of the law and its effect on the industry, and proposed considerable revision in the rules governing use of loss carryovers (Sections 381 and 382).

In explaining his view Mr. Barkin pointed out that "Section 381 of the Code permits the carryover of net operating losses and certain other tax attributes by successor corporations in the case of specified tax-free reorganizations and tax-free liquidations of a subsidiary. Section 382 is designed to limit the sale of corporate net operating loss carryovers as such, and to place appropriate limitations on the use of loss carryovers by successor corporations. In practice, however, these limitations to date have not prevented the "trafficking in corporations with operating loss carryovers, the tax benefits of which are exploited by persons other than those who incurred the loss," referred to by the Committee on Ways and Means in its Report on the Internal Revenue Code of 1954. (Report on HR 8300, p. 42.)

He quoted *Business Week* (January 14, 1956): "Tax-Loss Mergers Bloom Again." Citing the plethora of advertisements appearing in the *Wall Street Journal* and other financial publications, inviting buyers and sellers of "loss corporations," *Business Week* noted that "business is picking up again in the buying and selling of companies that have tax-loss credits . . . For a year or so (after the adoption of the 1954 Code), traffic in tax-loss companies fell off. The ads and the merger announcements got sparser. Now, however, corporate tax experts have had a good chance to analyze the revised rules and they're ready to go ahead again with mergers involving tax-loss situations . . . Robert S. Holzman, professor of taxation at New York University's business school, says: 'There are just as many profitable companies seeking loss situations today as there were before 1954—probably more.' "

"The abuse of the carryover provisions by persons intent on obtaining a tax advantage," Mr. Barkin said, "has had particularly deleterious effects on the textile industry. The owners of corporations which had suffered losses from operations during the recent periods of depressed demand have been discouraged from rehabilitating their businesses. New interests have acquired con-

trol of these corporations and have proceeded to liquidate part or all of the loss corporation's assets. In spite of the fact that these persons had not suffered any losses, they have avoided taxes on their profitable businesses by applying the loss carryovers of the liquidated corporations against the profits of the successor corporation.

"The wholesale exploitation of the loopholes in Sections 381 and 382 of the Code has accelerated the demise of the textile industry. Many millions of dollars in taxes have been avoided through the use of a variety of carryover devices. Such tax avoidance is clearly not in the public interest. It is essential that Sections 381 and 382 be revised to eliminate loopholes so that the intent of the Congress in enacting these provisions shall not be evaded.

"Instead of preserving equity among taxpayers, removing impediments to risk-taking and increasing the countercyclical effects of taxes, the application of Sections 381 and 382 of the Code has created windfall tax gains for certain taxpayers, discouraged enterprises from making investments necessary for their survival, and encouraged the liquidation of existing business. This perversion of the purposes of the loss carryover provision has caused severe distress among the thousands of workers who have lost their jobs as a result of plant liquidations. In the textile industry, which has been suffering from the impact of several major factors tending to depress the economy of the industry, the use of Section 381 of the Code as an additional spur to mill liquidations has aggravated the industry's problems of adjustment and accelerated its demise. Instead of serving to stimulate constructive efforts to rehabilitate the industry, loss carryovers have been made use of by financial manipulators to the detriment of the industry and the public interest."

Impact of Section 381

Mr. Barkin pointed out that "the adoption of Section 381 of the Internal Revenue Code of 1954 injected a new and disturbing element into this situation. The owners of corporations which had suffered substantial losses found that they owned a valuable asset in their corporate tax-loss position. People who were operating a profitable enterprise were anxious to acquire the loss corporation's "tax shoes" so they could reduce their tax liability. Lured by the blandishments of attractive offers of tax-free exchanges of stock, complete with the advantages of obtaining stock in a listed corporation in place of securities of a closed corporation, many could not resist the opportunity of selling out. Why continue the competitive struggle with its demands for new investments for modernization when selling out yields a handsome and quick return?

"In many cases the interests which acquired these loss corporations had no interest in continuing the operation of the company's facilities. Once the right to the loss carryover was achieved, the acquired plant or plants were liquidated. Frequently the funds yielded by textile mill liquidations were used by the new owners to buy up non-textile companies. Thus the resources of this depressed industry were diverted from the much-needed task of rebuilding it . . .

"Information on the effects of the use of the carryover device is necessarily limited. Many of the deals are made between closely held corporations and details are not divulged. Information made available by public corporations is also limited. Nevertheless, sufficient information has been made public to yield a clear picture of some of the patterns which have developed in the exploitation of this tax loophole in the textile industry."

Defects in purchase rule

Turning to the Code provisions that permit these results, Mr. Barkin criticized the looseness of the "purchase" rule of Section 382(a). That subsection denies a corporation the carryover of net operating losses from prior years if the 10 largest shareholders of the corporation as of the end of the year have increased by 50 or more percentage points their ownership of the market value of the stock within a two-year period and the corporation does not continue to carry on substantially the same business. As to that subsection, Mr. Barkin said:

"Section 382(a) defines purchase so narrowly that it does not apply to many cases in which effective control is purchased. Before disallowance of the carryover is imposed, paragraph (1)(A) of this section requires that any one or more of the 10 persons who own the greatest percentage of the fair market value of a corporation's stock at the end of the taxable year must have increased their holdings by at least 50 percentage points over their holdings at the beginning of the taxable year or the beginning of the prior taxable year. This means that, if such persons increased their holdings from 10% of the total to 50% (an increase of 40 percentage points), the limitation of Section 382(a) would not apply. Obviously, ownership of 50% of a corporation's stock represents control; this is the measure of control recognized in Section 269 of the Code, relating to the acquisition of control of a corporation to evade or avoid income tax.

"The period of time during which a change in the trade or business (after the purchase of a corporation) would result in the disallowance of a loss carryover under Section 382(a) is inadequate. The limitation of Section 382(a) to cases in which stock ownership has changed since the beginning of the current taxable year or the beginning of the prior year means that the old business need often be continued for only a little more than a year. For example, assuming that a corporation's taxable year is the calendar year, if its stock changes hands in December 1956, then the business carried on by the corporation at that time need be continued only until January 1958. In special cases this period may be even further reduced. For example, if the stock of the loss corporation had been owned prior to its sale by another corporation with which consolidated returns had been filed on a calendar-year basis, the period from the beginning of the calendar year to the date when the sale of stock broke the affiliation would be a period for which a return should be filed and, therefore, a taxable year within the definition in Section 441(b) of the Code. The period from the date of sale to the end of the calendar year might be a separate return period and also, by definition, a taxable year. If the sale took place on November 30, 1957, and the loss business was terminated on January 2, 1958, it might be argued that there had been no change in stock ownership since the beginning of the taxable year 1958 or the beginning of the prior taxable year on December 1, 1957, and that Section 382(a) accordingly had no application.

"If a change in the nature of a business occurs within the specified period after a corporation's purchase, the loss carryover is denied under Section 382(a) for the year in which the change in business occurred; however, any net

operating loss deductions made in prior years are not affected. This means that a corporation can purchase a loss corporation, offset the entire amount of the carryover against profits in the first taxable year or two, and then terminate the business of the former loss corporation without penalty."

Defects in reorganization rule

Subsection 382(b) serves to reduce the loss carryover of a corporation if its shareholders wind up with less than a 20% interest in the combined entity; it requires a pro tanto reduction of the carryover to the extent that the shareholders' interests fall below this 20% mark, the carryover being reduced 5% for each 1% it falls below 20%, so that, if the shareholders of the loss corporation have 19% of the stock of the combined company, the carryover is reduced 5%.

Mr. Barkin criticizes Subsection 382(b) for two main reasons: there is no requirement that the business be continued if the loss is to be used; further, the exclusion of the liquidation of a subsidiary permits the purchaser to acquire the loss corporation as a subsidiary and then liquidate it and use its losses without limitation.

As we reported to you here last March (8 JTAX 146), the Advisory Group of Practitioners to the Mills Subcommittee raised this question of using liquidation-of-subsidiary route as a means of avoiding the limitations on loss carryover. They said, "Can taxpayers avoid both subsections of Section 382 by acquiring the stock of the loss company in a Section 368(a)(1)(B) [stock for stock.—*Ed.*] reorganization and then liquidating the company under Section 332, where acquisition of the assets directly in a Section 368(a)(1)(C) [stock for assets.—*Ed.*] reorganization would bring Section 382(b) into play? Can the shareholders of the acquiring company purchase the stock of the loss company and then merge it into the acquiring company relying on the common-ownership provisions of Section 382(b)(3) to escape the limitations of the section? It is very clear that present law has created a very difficult situation for the Service." That Group considered recommending a rule similar to that underlying the recent *Lisbon Shops* decision that carryovers can be applied only against income from the business which suffered the loss, but finally decided to recommend limiting loss carryovers of acquired companies to 50% of the price paid for them.

Mr. Barkin makes no such recommendation, for such a recommendation involves no fundamental change. He would require that the business be continued after a reorganization. He said:

"Under Section 382(b), relating to the limitations on loss carryovers where changes in ownership are the result of a reorganization, there is no requirement that the successor corporation continue to carry on the same trade or buisness. This omission creates a most significant loophole since it permits persons desiring to obtain tax loss carryovers to do so without regard to the disposition of the business of the acquired loss corporation."

In addition, he would treat a stock-for-stock reorganization like a purchase. As to this, he said:

"In listing the types of reorganizations which are subject to the limitations of Section 382(b), the statute omits transfers which are the result of exchanges of stock for stock [Section 368(a)(1)(B)]. This means that the owners of the loss corporation involved in this type of reorganization need not obtain a 20% interest in the successor corporation in order for the latter to use the carryover. The successor corporation can achieve this end either by transferring income-producing assets to the loss corporation or by liquidating it so that the carryover would go to the parent company. In the latter case, the transaction should be treated in the same manner as a purchase of stock and be made subject to Section 382(a).

"While the Senate Finance Committee's report on HR 8300 states that 'the 20% (continuity of interest) requirement [in Section 382(b)] cannot be watered down by inserting one or more corporate entities between the corporation with the loss and the corporation deducting the loss,' it is silent on the possibility of watering down the 20% requirement through other devices. For example, in a reorganization in which substantially all the assets of a loss corporation are acquired by a subsidiary (which can be newly created) of a profitable corporation in exchange for the latter's stock, the continuing interest of the loss corporation's stockholders can be watered down as long as they receive stock in the parent company of a value of 20% of the fair market value *of the subsidiary*. The parent company can then make use of the loss corporation's carryover by transferring income-producing assets to the subsidiary which had acquired the loss corporation's assets."

Section 269 no bar

Mr. Barkin, like most of those who have studied the problem, places little reliance on Section 269 (Section 129 of the 1939 Code). The old section was widely regarded as impotent in view of the Treasury's failure to win a single case under it. And the 1954 addition (a presumption that the purpose of an acquisition is avoidance if the price of the stock is low in relation to the tax basis of its assets and its tax benefits) is complicated and untested. Furthermore, there is the remark of the Committee Report on this section that it is not applicable if 382(b) applies. Does this mean that giving the old stockholders only 19% and accepting a 5% cut in the carryover will make Section 269 ineffective? Mr. Barkin concluded that "the only effective remedy for the widespread abuse of the carryover provisions is to close the loopholes in Sections 381 and 382. This can be accomplished by denying use of the carryover in the case of a change in ownership of a corporation if a business is terminated at any time during the three years subsequent to the date of the change. This rule should be applied whether the change in ownership is a result of a purchase of the corporation's stock or a reorganization. This would put an end to the exploitation of tax benefits by persons other than those who incurred the loss through trafficking in corporations with loss carryovers."

Criticizes Mills Group 50% proposal

"The remedy proposed by the Advisory Group on Subchapter C of the Internal Revenue Code of 1954 would limit the available carryover of an acquired business to 50% of the consideration paid for that business and would delete the requirement for continuation of a business from Section 382(a)(1)(C), substituting a provision in Section 269 making it a presumption that an acquisition is for a purpose condemned under that section if the business of the acquired corporation is discontinued.

"Unfortunately, this remedy appears to create more problems than it solves. The proposed limitation of carryovers to 50% of the consideration paid for a business is at best arbitrary. At worst, it could operate capriciously in per-

mitting certain corporations the full benefit of carryovers in spite of the tax avoidance motive involved in an acquisition while preventing other corporations from utilizing their full carryover rights where no abuse is involved. The relationship between carryover and the amount paid for a loss corporation is not the crucial consideration. A loss corporation with relatively substantial net assets might well be acquired by another corporation at a price several times the amount of its carryover (thus assuring allowance of the full carryover) yet subsequent events might clearly establish the abusive character of the transaction. The crucial question is whether the business formerly conducted by the loss corporation is continued by the acquiring corporation. It is the liquidation of such businesses that has constituted the gross abuse of the carryover provisions, with its dire consequences for the affected workers and communities.

"The Advisory Group recognizes that 'the proposed mathematical tests would not reach such cases (acquisition of a "shell" corporation or a going business with no idea of continuing it).' However, the protection which the Advisory Group suggests against this type of abuse is actually weaker than the present provision. Under Section 382(a)(1)(C) a purchased corporation which has not continued the trade or business conducted before its purchase automatically loses its carryover. The Advisory Group would delete this objective rule and substitute for it a general proposition that the discontinuance of the corporation's trade or business shall be considered 'a presumption that (the) acquisition is for one of the purposes condemned by section 269.'

"We have commented above on the ineffectiveness of Section 269 as a bar to abuse. The addition of the presumption in sub-section (c) in the 1954 revision of the code has not materially enhanced the effectiveness of Section 269. The addition of another presumption can hardly accomplish the stated purpose of the Advisory Group. Indeed, the Group's report admits that the proposed addition 'is cast in general terms which are uncertain in application to specific cases.' "

Conclusion

"The Congress has recognized the need to restrict the carryover of losses in accordance with economic realities rather than such artificialities as the legal form of a reorganization. It has sought to insure that the benefit of the carryover shall not be exploited by persons other than those who incurred the loss. However, the limitations provided in Section 382 of the Internal Revenue Code of 1954 have proved to be too loose to accomplish its purpose."

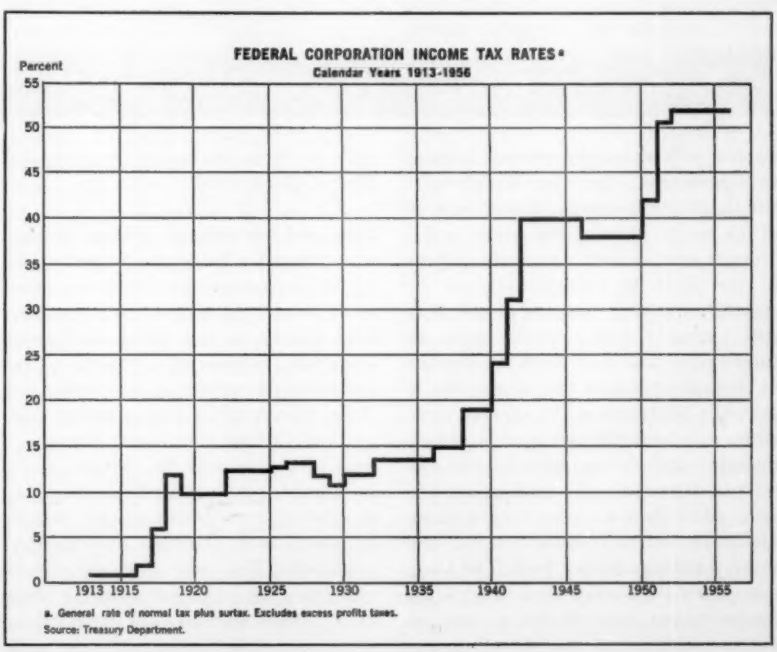
Mr. Barkin produced for the Committee a number of case histories of acquisitions of textile companies by others, showing the tax benefit flowing to the purchasing company as a result of the acquisition. These will be published in the proceedings of the Ways & Means Committee hearings, which should be available soon from the Government Printing Office. These case histories, together with excerpts from annual reports of purchasing companies, should make useful reading for practitioners concerned with operation of tax loss carryovers. ☆

Tax Foundation sees little aid for small business in corporate tax cut

WE ARE so accustomed nowadays to high corporate income taxes and the huge amounts of revenue raised by them that it is hard to realize they are a World War II and postwar phenomenon. If that seems incredible, take a look at the adjoining chart.

The chart is taken from a recent study by the Tax Foundation on "Re-examining the Federal Corporation Income Tax." The report concedes that reducing this tax will necessitate major changes in Government finance. "The immediate justifications for the corporation income tax," it says, "are the pragmatic ones that it produces a large revenue, serves to diversify the tax system, and is relatively easy to administer. Business is taxed because government needs revenue, experience shows business can pay taxes, and it appears expedient to tax business. For the last six fiscal years the corporation tax has produced an average of more than $20 billion, or nearly one third of total budget receipts. The Bureau of Internal Revenue made a comparison of costs of collection for the fiscal year of 1947, and found that while the corporation tax accounted for 25% of total tax collections it required only 10% of the man-hours employed in collection."

As the introduction to the study points out, its purpose is to examine "the major issues involved in recent



proposals for modification of the corporate rate structure, and consider the question of whether any substantial modification is called for in the structure of this tax."

The study concludes that "a progressive corporation income tax would not improve the equity of the tax system. To the extent that the burden of such a tax falls on stockholders, it would hit heavily the growing number of stockholders in the middle and lower income groups who own stock in large corporations. To the extent that the burden of such a tax is shifted forward to consumers, a progressive corporation tax would, paradoxically, be a regressive tax—it would fall more heavily on middle and lower income groups than do present Federal excise taxes.

"Thus a progressive corporation income tax cannot be justified on the principle of ability to pay, for its burden is not related to the size of the incomes of the individuals concerned.

"Even if the corporation tax is regarded as an excise or special benefits tax on corporations as such, no basis for progression can be found. The benefits of government services to corporations are not related to a corporation's *net* income—profitless corporations also receive these benefits.

". . . The question is considered of modifying the corporation tax as a means of relieving the tax burdens of small business. It is shown that the present surtax exemption serves to mitigate the burden of the present tax on small corporations. It is also shown that further relief from the burden of the corporation tax would do little to meet the difficulties of small business in general. The vast majority of small businesses are not incorporated, and their problems are not primarily due to high taxes. It is not evident that special tax relief is an appropriate means for dealing with the peculiar difficulties of small business.

"Nevertheless, it is evident that the normal tax rate of 30%, the only part of the tax to which about four-fifths of taxable corporations are subject, is relatively high. It is a Korean War rate, the reduction of which has been postponed for four successive years.

"It is concluded that when substantial tax revision and reduction become possible, the change most needed in the corporation income tax is a reduction in the normal tax rate. A reduction in the normal tax rate would be of more importance to the economy than any modification of the tax for special purposes. It would be relatively favorable to small corporations; it would reduce the marginal rate on additional income for growing concerns; it would add to the sources of funds for investment; it would lower the total tax rate on all corporations and so mitigate the distorting effects of the present rate on business decisions." ☆

New accounting decisions this month

Capital gain on royalty contract received in liquidation. Taxpayer liquidated a wholly owned company, taking over all of its assets. One of the assets was a contract with another corporation whereby the latter, in consideration for the transfer of certain patents, promised to pay patent royalties based upon its future sales. The court finds the promise to pay too uncertain and speculative to permit a valuation at the time of liquidation. Accordingly taxpayer is not required to include any value for the contract in determining his gain on liquidation. All royalties received by him individually after the liquidation are held to be taxable as capital gain. The Commissioner's contention that part of the payments was received for a covenant not to compete and was, therefore, taxable as ordinary income is overruled. *Hoy,* TCM 1958-28.

Pennroad has ordinary income on sales of its extensive Baltimore property. Taxpayer corporation had been organized in 1828 to hold and develop extensive land acreage in and around Baltimore. From the beginning it regularly and continuously engaged in developing portions of its property and in selling other portions. It held itself out as having real estate for sale both for industrial and residential purposes and planned and conducted its activities toward making the parcels more attractive to prospective purchasers. The court holds the sales of real estate by taxpayer were not those of a passive investor, but were an integral part of its business and were made to customers in the ordinary course thereof. Accordingly, gains on the sales were taxable as ordinary income. Various parcels which had been rented at nominal rentals at the time of sale were not shown to have been property used in a trade or business, but were considered as held primarily for sale to customers. A similar conclusion was reached with reference to property originally held for a proposed right of way for a related railroad corporation, since the railroad extension plans had been abandoned back in 1925. *Pennroad Corp.,* 29 TC No. 98.

Ordinary income on sale of subdivided farm. From 1946 to 1953 taxpayer sold 40 parcels of land from acreage which had been used as a farm and nursery. During that same period she had improved the land by installing streets, a sewerage system, water mains, and gas and electric utilities. All sales were handled through her attorney without any advertising and without employment of brokers. The court finds the lots were held primarily for sale to customers and holds taxpayer received ordinary income from the sales, rather than capital gain. *Est. of Nieman,* TCM 1958-24.

Dealer in real estate fails to prove lots sold were held as investments. Gain realized by a dealer in real estate from the sale of 41 residential lots in the years 1948-1951 was reported as long-term capital gain. The court, although recognizing that a dealer may hold some properties for investment, finds that there was no attempt by taxpayer to segregate his investment property from the rest, and holds the entire gain ordinary income having resulted from the sale of property in the ordinary course of business. *Culley,* 29 TC No. 113.

Ordinary income on sale of rental units in defense-housing project. The Commissioner determined that defense-housing units sold by taxpayer were held primarily for sale to customers in the ordinary course of a trade or business and that the sales resulted in ordinary income rather than capital gain. Taxpayer challenged the determination; he claimed that he was in the business of renting defense housing and that the sales constituted not a business but a liquidation of his investment. After considering taxpayer's selling activities and the volume of sales, the Tax Court held

that taxpayer was simultaneously engaged in the dual business operations of sales and rentals of housing units. This court affirms. *Monday,* CA-6, 2/20/58.

Inventor retained substantial rights; transfer was a license, not a sale. Taxpayer-inventor transferred his patents to a corporation created by his employer, receiving a 20% stock interest and the right to royalty payments. However, he retained several important rights, the most critical of which was the right to license any subsequent employer if he left this employer. The district court held that taxpayer retained such substantial rights that the transfer was a license, not a sale, and that the payments he received are ordinary income. This court affirms. *Watkins,* CA-2, 2/26/58.

Election to expense research covers all expenses. The IRS rules that a taxpayer who has elected to expense research and experimental costs must use that method for all such expenses. It is not allowed to amortize any or to write them off on abandonment of the project. Taxpayers who have elected the expense method but have not deducted all expenses must file claim for refund to get the benefit of them; if they attempt amortization or claim an abandonment loss, it will be denied. *Rev. Rul.* 58-74.

Corporation not taxable on "kickbacks" paid to its purchasing agent until recovered. Amounts received by a corporate purchasing agent as "kickbacks" from the suppliers are held to have been received by the agent individually under a claim of right, and were not accruable income to the corporation in which the agent was also a minority stockholder and nominal president. The fact that, in a state court proceeding, it was decided long after the taxable year that the "kickbacks" belonged to the corporation did not establish any rights in the corporation prior to the litigation so as to require it to accrue the income in the earlier taxable year. *All Americas Trading Corp.,* 29 TC No. 97.

Can deduct increase in state taxes for noncontested IRS changes [*Non-acquiescence*]. Taxpayer, an accrual basis corporation, did not contest Federal income tax deficiency arising out of certain items. It did claim additional New York State franchise tax on the ground that the state would disallow the items also. The Commissioner argued the deduction was not allowable in the year the transactions occurred. The Tax Court agrees with taxpayer that such deduction is allowable for the year to which the adjustments are made; taxpayer need not await assessment or payment of the tax. *Chesbro,* 21 TC 123, *Non-Acq.* IRS 1958-7.

DEDUCTIBILITY

Bookmaker's expenses deductible. Taxpayer was a bookmaker, an illegal enterprise under Illinois law. The payment of wages and rent for such a business is also criminal under Illinois law. Accordingly, the Commissioner disallowed taxpayers' expenses for wages and rent as being in violation of state policy. The Supreme Court affirms the Seventh Circuit in allowing the deductions. To disallow these expenses would virtually tax this business on its gross receipts, while the general intent of Congress is to tax only net income. The Court also notes that the Federal gambling tax is an allowable deduction, showing a recognition of gambling as a business for tax purposes. [It is disappointing to tax practitioners that the Supreme Court did not take the opportunity to resolve the conflict as to whether the Tax Court has to follow the case law in the circuit to which the case would be appealed. The Seventh Circuit in this case criticized the Tax Court for not following the Seventh Circuit's prior opinion in *Doyle,* 231 F.2d 635. See 8 JTAX 228.—*Ed.*] *Sullivan,* Sup. Ct., 3/17/58.

Mutual-ditch assessment for capital improvements not deductible [*Certiorari denied*]. Taxpayer-farmers receive their water from certain non-profit mutual-ditch companies. They claimed as business expense deductions the assessments paid to these companies. The Commissioner contended that in view of the use to which these payments were put, e.g., retirement of bonds and purchase of capital items, they must be treated as capital. The Tenth Circuit held the payments went to expand the water distribution system and thus were capital in nature. *Akin, cert. den.,* 3/3/58.

Truckers' overweight fines are not deductible. Taxpayers are engaged in the trucking business and seek to deduct fines incurred for violating state weight-limit statutes as an ordinary and necessary business expense. Some of the fines were intentionally incurred because of the high cost of compliance; other fines were innocently incurred due to temperature expansion of the cargo, shifting of the cargo and incorrect manifests. Affirming the courts of appeal, the Supreme Court holds the fines non-deductible. To allow the deductions would frustrate state policy "by increasing the odds in favor of non-compliance." The record does not show that the unintentional violations were unavoidable and hence the fines were not a "necessary" business expense. However, even if the fines were incurred despite the exercise of due care, they would not be deductible because of the frustration of state policy. In *Rossman,* 175 F.2d 711, the statute imposing the fines distinguished between wilfull and innocent violations; this is not the case here. *Tank Truck Rentals, Inc.; Hoover Motor Express Co.,* Sup. Ct., 3/17/58.

Stockholder must capitalize his legal expense in derivative action. Taxpayer incurred legal expenses in a stockholder's derivative action against directors of a corporation. This court affirms the Tax Court holding that the expenses must be capitalized as part of the basis of the stock. The action benefited the corporation and other stockholders, and the fees were really an expense of the corporation. In paying them, taxpayer made a contribution to capital. *Steckel,* CA-6, 2/24/58.

Can't deduct legal fee in divorce though income property was disputed. When taxpayer and his wife were divorced there was a dispute over whether certain income-producing properties were community or separate. In settling this matter, taxpayer spent $17,000 in legal fees. The court holds taxpayer cannot deduct these fees; they were incurred in defense of title and must be treated as capital. *Harris,* DC Cal., 1/6/58.

Deduction allowed though underpayment was not discovered until later year. Taxpayers had been partners in a farming business. They distributed the farms to their controlled corporations and the partnership thereafter handled only the marketing functions, buying the crops from the corporation at the going market price. The bookkeeper for the partnership included the pretransfer cost of growing these crops as a partnership deduction. However, he also subtracted these costs from other expense payments due the corporations and, ap-

parently, (the facts are not too clear) claimed for these latter expenses only the net paid. Three years later the erroneous charge to the corporations was discovered and the partnership made the additional payment to them and claims refund arising from putting this additional payment as a deduction of the year of transfer. The court allows it. [It is hard to see why this case came to litigation; there seems to be no tax issue at all, merely confusion on all sides about the effect on taxable income of the somewhat complicated bookkeeping.—*Ed.*] *Peters,* DC Calif., 1/29/58.

Cost of filling and grading lot deductible as repair. An expenditure by taxpayer for filling in and grading a vacant lot whose drainage had been blocked by neighboring construction, in order to prevent water from seeping into taxpayer's storage facilities on a contiguous lot, is held to be deductible as a repair expense. The work was done, not to convert the lot to a new use, but to restore it to its former ordinarily efficient operating condition. *Southern Ford Tractor Corp.,* 29 TC No. 90.

Death benefit payments to stockholder-employees not deductible as compensation. Taxpayer's stock was owned by some of its employees and pensioners. One of the restrictions on the stock was that, upon death of a stockholder, his estate was required to offer the stock to taxpayer at its par value of $20, which was considerably below the true value. The taxpayer adopted a plan of paying special death benefits to the estate or beneficiaries of the stockholders equal to the dividends over a five-year period that would otherwise have been payable on the stock surrendered after the stockholder's death. The plan was discretionary with taxpayer and in at least four instances the special benefit was not paid. It deducted such payments as compensation. The court finds these payments were made to mitigate the hardships to an estate caused by the sale of the stock at a price less than its true value. Since there was nothing in the record to show that the employees who were also stockholders, and who were the only ones entitled to the death benefits, rendered any special services justifying financial recognition that discriminated against other employees, the court concludes that the payments were made in respect of the stock and not in respect of services rendered, and could not therefore be deducted as compensation. *Graybar Electric Co., Inc.,* 29 TC No. 89.

Building demolition held expense, not capital investment [*Acquiescence*]. The Tax Court found that taxpayer purchased building without an intent to demolish. It demolished only after ordered to do so by the fire department. The cost of the demolition is a deduction, not a capital investment. *Chesbro,* 21 TC 123, *Acq.* IRB 1958-7.

Payments to utilities for construction are a cost of development despite possibility of recoupment [*Acquiescence*]. Taxpayer-corporation paid to a water company the cost of constructing mains to supply a new development. The corporation would receive a portion of billings in the development by the utility for ten years. The court holds that, despite this possibility of recoupment, the construction payments are part of the cost of the development. They were unconditional payments and treating them as such would properly reflect income. *Gersten,* 28 TC 756, *acq.* IRB 1958-7. . . . Similarly *Colony, Inc.* 26 TC 30, *Acq.,* IRB 1958-7.

WHAT IS INCOME

Contestant answers two questions and wins tax-free jackpot [*Non-Acquiescence*]. Ray Campeau answered his telephone on the evening of 11/20/49. It was "Hollywood Calling—Film of Fortune," a radio and TV giveaway program. Ray was asked two questions which he answered correctly and for which he received cash and merchandise valued at $12,300. The awards were held to be nontaxable gifts. Ray did not perform any services; he merely satisfied a condition to a gift. [1954 Code now defines gross income to include prizes and awards—*Ed.*] *Campeau,* 24 TC 370, *nonacq.* IRB 1958-3.

Compensation stock had value despite no-sale restriction. For his services in facilitating a public offering of stock in Servomechanisms, Inc., taxpayer received some 8,000 shares on his assurance (required to meet S.E.C. standards) that he would hold them as an investment. Because of the speculative nature of the stock and this restriction on sale, he argued that the shares had no value in the year of receipt. The court holds that while these factors reduce the value of the stock, they do not destroy it. It notes that the range of bid-and-asked quotations during the year was from 3¾ to 4⅞, and concludes the fair market value of taxpayer's restricted shares was $3.50. *Conroy,* TCM 1958-6.

Corporate payments to president's widow a gift. Payments made to the stockholder-widow of the president by family corporation, equal to the deceased's salary for two years, are held to constitute an exempt gift rather than compensation for service rendered to the payor. The fact that the corporate resolution also authorized the same death benefits for the wives of two of the present officers did not tend to detract from the otherwise clear evidence of gift. *Luntz,* 29 TC No. 72.

Seller of stock not taxable on dividend applied against purchase price. [*Certiorari denied*]. Taxpayer agreed to sell his stock in a controlled corporation. The buyers made a down payment and reassigned the stock to the seller as collateral security for the payment of the balance. A dividend declared on July 20th and payable to stockholders of record on July 28 was held by the Tax Court to be taxable as ordinary income to the seller, even though the agreement of sale provided that the dividend would be applied against the purchase price. The seller owned the stock on the declaration and record dates. The circuit court reversed. It was the buyers who received the taxable dividend. Having obligated themselves to pay the purchase price, they used the dividend to reduce the unpaid balance owed for the stock. In a marginal note alongside the stockholders' resolution declaring the dividend, the buyers acquiesced in the declaration, showing, the Seventh Circuit held, that they had an equity in the stock at that time. *Miller, cert. den.,* 2/3/58.

Officer-stockholder not taxable on funds embezzled from firm. Taxpayer was minority stockholder and president of a family firm. For several years he charged personal expenses to the company and had appropriated checks due it; the amounts involved were very large; the deficiencies here totaled over $2 million. There were several bank accounts in the corporation name on which only taxpayer could write checks. He secretly deposited company checks in these accounts and withdrew the proceeds. These

funds, which had been returned to the corporation and on which the corporation had been held taxable in other litigation, were, the court holds here, embezzled and not taxable to taxpayer. However, the large totals of personal expenses charged to corporate expense were income of the taxpayer. The court also finds that, because taxpayer retained a right to revoke a trust created for his wife many years ago, the government, as creditor, can enforce tax liens against it, New York law being clear that a grantor's creditors can proceed against revocable trusts. *Peele,* DC N. Y., 2/4/58.

Check received in 1945 not income in 1950 [*Acquiescence*]. A check for income received by taxpayer-corporation in 1945 was not cashed, but was held for possible use in an action against the maker. After entry of judgment on the action in 1950, the corporation requested a new check to replace the old one. The maker refused on the ground that an intervening judgment had settled all accounts between them and the corporation's counsel informed the corporation that the old check was uncollectible. The court finds no proper basis for inclusion of the check in the taxable income of the corporation for 1950. *Western Products Co.,* 28 TC 1196, *acq.* IRB 1958-7.

Escrow payments originally expensed are income when refunded. Upon acquisition of a defense-housing unit, taxpayer made escrow payments to the mortgagee to be applied in payment of estimated taxes, assessments, and insurance premiums. When the unit was sold, the mortgagee refunded the escrow accounts. The Tax Court held that, since taxpayer never reflected the original escrow payments as an adjustment of the cost or selling price of the property but took them as an expense deduction, he is required to report the refund as ordinary income. This court affirms. *Monday,* CA-6, 2/20/58.

Trust income not taxable to beneficiary [*Acquiescence*]. Taxpayer, the beneficiary of a trust and of an estate, entrusted their operations, both before and after she became entitled to the corpus, to her lawyer, who pocketed some of the income. She later sued the lawyer for an accounting and received the withheld money. The Tax Court holds that taxpayer is not taxable on that portion of her recovery which represented income accrued prior to the date she became entitled to the corpus of the trust and estate on the ground that this was distributable to her as beneficiary and taxable in the year due to the trust. *Western Products Co.,* 28 TC 1196, *acq.* IRB 1958-7.

Indians taxable on sale of cattle raised on allotted lands. Income derived from the sale of cattle raised on allotted and restricted Indian lands while such lands are held by the U. S. as trustee is not income derived directly from the land and is, therefore, includible in taxable income. [*Rev. Rul.* 56-342 distinguished. That ruling held "grazing fees" for the use of the land as pasture were not taxable because they were income from treaty lands.—*Ed.*] *Rev. Rul.* 58-64.

OTHER DECISIONS

Corporation has capital gain on liquidation of land holdings. The bondholders of a railroad organized taxpayer-corporation to "liquidate" their large land holdings acquired on foreclosure. Since the corporation, as an entity separate from its stockholders, was formed for the business of selling properties, the Tax Court held all gains were taxable to it as ordinary income. This court reverses, with one dissenter who would uphold the Tax Court opinion. The majority, however, view the activities of the corporation as mere passive liquidation without the extensive activity necessary to constitute a business. *Alabama Mineral Land Co.,* CA-5, 12/30/57.

Installment payments to cancel contract are income as received. Taxpayer, on the accrual basis, agreed in 1945 to accept $30,000 a year for five years beginning in 1946 to cancel a profitable contract. The $150,000 was not income in 1945. The court likens the agreement to an employment contract under which the employee is taxable only as the salary is earned. The payment in question merely replaces earnings the taxpayer would have received under the contract for a period of years. *Appalachian Power Co.,* Ct. Clms., 1/15/58.

Gain on involuntary conversion taxable if no proper replacement occurs. Taxpayer was forced to give up and sell his poultry business under the threat of condemnation by a state highway commission. He used the proceeds from the "forced" sale to acquire rental properties and a gasoline filling station business. Taxpayer is held not entitled to the nonrecognition provisions of 1939 Code Section 112(f) since there was no replacement of property "simular or related in service or use" to the property converted. The court notes that it cannot decide the case on the basis of an appeal to equity, but that to secure the benefits of a tax-exemption statute the taxpayer must show that he comes clearly within its terms. *Collins,* 29 TC No. 75.

Sale pursuant to court order in anti-trust case not an involuntary conversion. A federal court's order to a corporation to divest itself of ownership of certain stock because the ownership violates the anti-trust laws is not the taking of stock for public use. Accordingly, a sale of the stock pursuant to order is not an involuntary conversion and any gain on the sale is recognized even though the proceeds are reinvested similarly or in similar shares of stock. *Rev. Rul.* 58-11.

Salary check mailed in December income when received in January. Taxpayer's employer customarily mailed his salary check to his bank for deposit. The check dated December 31 was received in January in the ordinary course of the mails. The court holds it was income in January. [The opinion does not discuss the reason for this holding and few facts are given.—*Ed.*] *Kuhn,* DC N. J., 1/3/58.

Can't avoid income by changing from cash to accrual basis. A common carrier was properly on the cash basis in 1949. Upon order of the I.C.C. it properly changed over to the accrual basis in 1950. When it filed its 1950 return on the accrual basis, the carrier omitted sums collected in 1950 on 1949 accounts receivable. The court holds the sums should have been included in 1950. The court cites Section 42 of the Code, which provides that "all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted . . . any such amounts are to be properly accounted for as of a different period." It concludes that the taxpayer is required to report every item of gross income that he receives in some years, and where, as here, there is no other year when it could properly be reported, then the year of receipt is the time the item is to be included in gross income, even

though taxpayer is on the accrual basis in that year. *Advance Truck Co.*, 29 TC No. 74.

Vacation pay rights held vested at 12/31; accrues then. A taxpayer published to its salaried employees a plan under which employees with service at 12/31 would be entitled to fixed vacations in the next year, proper adjustment to be made in case of prior layoff, resignation, death, etc. The IRS rules that the plan, though not a written contract with each employee, did give the employees a vested right in the vacation pay, and the liability of the employer is clearly established at 12/31 and capable of being computed with reasonable accuracy. The liability therefore accrues at 12/31. *Rev. Rul.* 58-18.

Additional N. Y. tax allowed for uncontested income additions; not for contested items [*Non-acquiescence*]. Having decided that taxpayer was not permitted to deduct certain items in 1948 & 1949, the Tax Court held that the New York State franchise tax that would be payable on such a contested addition to income (apparently it was agreed that New York would make the same additions to income) is not a proper deduction in 1948 and 1949. Deduction must be taken in the year of the settlement of the controversy. However, deduction is allowable in 1948 and 1949 for additional franchise tax on account of other adjustments the taxpayer did not contest. *Anchor Cleaning Service, Inc.*, 22 TC 1029, *nonacq.* IRB 1958-3.

Whether receipts were available was question for jury. Taxpayers were cash basis tobacco farmers whose crop was sold at auction. The checks for the proceeds of the auction sales were made out prior to February 28, the close of their fiscal year, but were not sent to them until after March 1. The Commissioner included the sales in the old year and, upon suit for refund, the court directed a verdict for the taxpayers. This court reverses — the facts as to the nature of the contract with the auctioneer and whether payment was available to taxpayers and merely deferred for their tax advantage were far from clear and should have been submitted to the jury. *Penn.*, CA-6, 1/3/58.

Royalties were ordinary income, though later applied against option price. Taxpayers leased a mine for a royalty and gave the lessees the option to purchase for $30,000, applying royalties paid against the option purchase price. The option was exercised six years after the lease was made. The court holds the royalties received under the lease during those six years were ordinary income since it was not certain the lessees were acquiring an equity in the property. *Elkhorn Queen Mining Co. (Wallace and Clarke, Trustees)*, DC Mont., 9/26/57.

Collections on mortgages by shareholders of dissolved corporation were ordinary income. Taxpayers received certain mortgages in a liquidation distribution from a corporation of which they were stockholders. In a previous decision the Court of Appeals held the mortgages had no fair market value when received. Upon collection, this court holds on remand that the proceeds received were ordinary income, since there was no sale or exchange of the mortgages by taxpayers. [The court does not discuss the numerous cases holding that collections in excess of value at date of liquidation are treated as in effect further distributions and therefore as capital gain.—*Ed.*] *Miller*, DC Ky., 10/31/57.

Patent "royalties" held part capital gain and part salary. Taxpayer claimed ownership of certain patent rights. He assigned the rights to his employer under an agreement whereby the employer agreed to pay him ½ of 1% of net sales with a provision for reducing the payments to ¼ of 1% if he left the job. The court holds that one-half of the payments were attributable to taxpayer's employment and taxable compensation for services. The remaining half of the amounts paid were for the sale of patent rights and are taxable as capital gain. Although there was some question of taxpayer's right to the patent, the court finds that his claim to ownership was never frivolous and was strong enough to induce his employer to sign the agreement. *Ost*, TCM 1958-18.

Escrow payment of judgment fixes time of deduction. In 1952 a trial court entered judgment against taxpayer in a personal injury action. In 1953 taxpayer, an accrual basis railroad, deposited the amount of the judgment in escrow and appealed the decision. At that time it deducted the amount paid. The judgment was affirmed and paid in 1954. The court holds that 1953 was the proper year for the deduction. In a quite brief opinion, the court notes that the liability and all costs had been entered on the taxpayer's books in 1953. This, it says, was a method of accounting which clearly reflected the correct deduction. *Texas Mexican Railway*, DC Tex., 1/15/58.

Can't deduct full claim; it was later settled for less. In 1952 and 1953, an individual who was an officer of taxpayer and another corporation drew a number of checks on the bank account of each corporation and deposited them in the account of the other, creating fictitious balances. In 1953, the bank brought suit against taxpayer for $120,000 of the bad checks. The liability was finally settled for $49,500 in 1957. The Tax Court denies taxpayer a $120,000 loss deduction for 1953. Even if taxpayer was on the accrual basis (and this is open to question), liability for the $120,000 was not fixed during 1953. *Williams Livestock Co.*, TCM 1958-17.

Loans by attorney deductible only as nonbusiness bad debts. Bad debts incurred by a practicing attorney who made individual loans and accommodation endorsements were held by the Tax Court to be deductible only as a nonbusiness bad debt. The attorney was not in the business of lending money, and the loans bore no proximate relationship to his law practice either when made or when they became worthless. This court affirms. *McNeill*, CA-4, 1/11/58.

Prepaid trustee's commissions deductible only when services are rendered. A cash basis grantor-beneficiary of a revocable trust may not deduct in the year of payment trustee's commissions paid in advance. He must apportion the payment over the period for which the trustee's services are rendered. However, that part of the trustee's services which are attributable to the trust's tax exempt income may not be deducted at all. *Rev. Rul.* 58-53.

Gain on sale negotiated by estate and consummated by beneficiaries taxed to latter. An estate negotiated for the sale of certain California acreage. In order to effect the sale under the conditions imposed by the purchaser and at the same time conform to California law, the estate was advised to distribute the property to the beneficiaries and have

them conclude the sale. The court finds that in both form and substance the sale of the acreage was made by the beneficiaries as owners and not by the estate. Gain on the sale was therefore taxable to them. A payment by the beneficiaries to the administrator from the sales proceeds for commissions due is held to be an administrative expense of the estate and not deductible by the beneficiaries. *Macdonough Estate,* TCM 1958-12.

Stepped-up basis denied surviving tenant-by-the-entirety. (Old Law). Taxpayer and her late husband held property as tenants by the entirety with the common-law right of survivorship. The court holds that under the 1939 Code the correct basis of the property to taxpayer as survivor is the cost at the time of the original acquisition, and not the higher value at the husband's death. Upon his death, taxpayer did not acquire such property "by bequest, devise, or inheritance," but instead took under the terms of the original conveyance, her estate being simply freed from the participation of her deceased husband. [Under the 1954 Code, the survivor's basis is his own cost plus the value of the decedent's interest at death.—*Ed.*] *Faraco,* 29 TC No. 76.

Cost of going business allocated to tangible and intangible assets. A corporation purchased all of the machinery, equipment and real property of a coal mining and distributing business for $1,000,000 and immediately thereafter continued the operations formerly conducted by the sellers. After weighing all the testimony, the court concludes that the assets purportedly sold for $1,000,000 were in fact worth only $650,000 and that only $650,000 out of the $1,000,000 paid for the business purchased is properly allocable thereto. The balance of the consideration or $350,000 is held to have been paid for nondepreciable goodwill or going concern value. *Copperhead Coal Co., Inc.,* TCM 1958-9.

Ordinary loss on bonds used as security for contract [*Acquiescence*]. Taxpayer, purchased U. S. government bonds and put them in escrow to guarantee the performance of a contract. When it sold the bonds on completion of the contract, it suffered a loss. The court held that the loss is an ordinary loss as it was a reasonable, ordinary and necessary expense of taxpayer's business. *Bagley and Sewall Co.,* 20 TC 983—*Prior non-acq. CB* 1957-2 *withdrawn and acq. in result only substituted. IRB* 1958-7. IRS says that, while disagreeing with treatment of the issue, it will not file an appeal. Similarly *Tulane Hardwood Lumber Co.,* 24 TC 1146, *acq.* IRB 1958-7; *Clark,* 19 TC 48, *acq.* IRB 1958-7; *Western Wine & Liquor Co.,* 18 TC 1090, *acq.* IRB 1958-7; and *Rev. Rul.* 58-40.

TECHNOLOGY NOT TIME

THE PRINCIPAL fact governing the depreciation rate of modern industrial equipment is obsolescence. Most productive equipment in the present-day mill, factory or refinery becomes obsolete before it wears out. The life of machinery today is determined by the pace of technological progress and not by the length of time it takes to tire out a piece of iron, nor by the life histories of the past, when technological improvements and advances were at a much slower pace. It is expected that government officials will begin to realize this fact. They are not as yet giving due emphasis to this in their decisions.—*F. V. Olds,* Asst' Comptroller, Chrysler Corporation, at the 13th National Tax Conference, Tax Foundation.

Leasehold not "land." Section 117 (j)(3), 1939 IRC (Sec. 1231(b)(4), 1954 IRC) provides for capital gain treatment of unharvested crops when sold with the land. Taxpayer sold the leasehold on which it grew crops, along with the crops. The court holds that it is not entitled to capital gain treatment on the unharvested crops because a leasehold is not "land." *Birdart,* DC Calif., 1/10/58.

Transfer of patent rights to controlled corporation is a sale. Taxpayer as administrator of her husband's estate transferred to her partner for a stipulated royalty the estate's undivided one-half interest in a pending patent. She owned the other half interest and together with the partner transferred to the partnership the exclusive right to exploit the patent, with the partnership agreeing to pay the required royalty to the estate. Later the partners formed a corporation and assigned all their rights to the corporation in consideration for percentage payments. The court construes the transfer of the patent to the corporation as a sale rather than a license on the ground that the partners had acquired all the substantial rights in the patent and intended to and did convey all such rights to the corporation. Furthermore, none of the percentage payments to the transferor-stockholders represented dividends or compensation for services rendered. Their corporate salaries were deemed adequate and the percentage payments were reasonable. *Hickman,* 29 TC No. 94.

Motion picture director has capital gain on sale of purchased story [*Non-acquiescence*]. The court finds that taxpayer, long a motion-picture director, bought three stories, intending to direct films based on them. In all three cases, after varied negotiations, he was required to sell the stories outright. Since they were held for use, not sale in the ordinary course of business, taxpayer had capital gain. *Anatole Litvak,* 23 TC 441, *non-acq.* IRB 1958-7. Similarly *MacMurray,* 21 TC 15, *prior acq.* CB 1954-1 *withdrawn, non-acq.* IRB 1958-7.

Gain constructively realized when sales proceeds were applied to debt. Attorneys who had in 1941 represented taxpayer in a derivative action against the directors of a corporation obtained in 1948 a judgment against taxpayer for their fees. In 1945 taxpayer had sold his stock, and a payment was due in 1949. These proceeds were paid by the buyer directly to the clerk of the court to serve as security in lieu of a bond for the judgment while being appealed. The Tax Court held that the gain on the sale was realized by the taxpayer in 1949 upon the payment into the court. The Tax Court reasoned that the payment was for taxpayer's benefit and would be used to satisfy his debt if the judgment were upheld or returned to him if not. This court affirms. *Steckel,* CA-6, 2/24/58.

Payment to cancel coal purchase contract ordinary income. In 1944, taxpayer acquired the right, irrevocable for ten years, to purchase all of the coal from mines in a certain area owned by another company. At the same time, taxpayer advanced funds to the mine owner to finance the mining operation. In 1949, taxpayer received $500,000 from the mine owner to whom it assigned "all our . . . interest in the agreement dated . . . 1944." The Commissioner contended the

receipt was ordinary income because the contract was not a capital asset and was not "sold or exchanged." The Tax Court held that the contractual right was a capital asset; the 1949 agreement extinguishing the right was equivalent to a sale. This court reverses. It finds the extinguishment payment was a substitute for ordinary income which taxpayer would have received under the contract in a relatively short time. One dissent: taxpayer's interest was analogous to that of a lessee; payments for lease cancellation have generally received capital gain treatment. *Pittston Co.*, CA-2, 2/11/58.

Loss cannot be carried back against income of dissolved subsidiary. Taxpayer incurred a net operating loss in 1947 attributable to the operation of its plastics division. The plastics business had formerly been conducted by a wholly-owned subsidiary which was liquidated into the taxpayer early in 1947. The Commissioner contends that the loss may be carried back only against the taxpayer's 1945 and 1946 income, while the taxpayer contends for a carryback against the subsidiary's income as well. The Court, following the "corporate thread," upholds the Commissioner's position. The subsidiary was not the "taxpayer" which suffered the loss. *Donovan, Inc.*, DC Mass., 1/14/58.

Remainderman's basis is not value when life tenant dies. Taxpayer here acquired certain stock upon the death of his aunt (in 1946) who had a life interest in it under the terms of the will of her husband who had died in 1912. When taxpayer sold the stock in 1949, the Commissioner asserted its basis was the 3/1/13 value, not, as taxpayer claimed, 1946 value. The court upholds the Commissioner and the district court. *Brandeis*, CA-8, 1/22/58.

50% stockholder, paying full corporate tax as transferee, has bad debt loss for other stockholder's share [*Acquiescence*]. Taxpayer and another were 50% stockholders in a corporation which liquidated. Taxpayer had previously paid $40,000 of back corporate income taxes, and in this year paid some $4,700 more. The court finds the records not adequate to upset the Commissioner's finding that half of the $4,700 was paid on behalf of the other stockholder. Since that stockholder was insolvent, taxpayer has a nonbusiness bad debt (a short-term capital loss) for that amount. Of the balance, the portion allocable to interest is fully deductible but that what represents additional corporate tax is a liquidation item and a long-term capital loss. *Gersten*, 28 TC 756, *acq.* IRB 1958-7.

Assignment of patent rights with retained right to terminate not a sale. Taxpayer assigned his patent rights to a corporation in return for royalties. Either party had the right to terminate at any time, with six months' notice. The court holds the right to terminate was not a condition subsequent to the transfer of title, but was a retention of a substantial right. Since the agreement was not a transfer of all the substantial rights in the patents, the royalties were received for a license to use the patents and are taxable as ordinary income. *Young*, 29 TC No. 92.

FNMA stock required to be purchased in conjunction with sale of mortgage is a capital asset. A mortgage dealer selling mortgages to the Federal National Mortgage Association is required under the provisions of the Association's charter act to purchase stock in the Association. The amount paid for such stock, the IRS rules, constitutes a capital investment, rather than a deductible business expense, and any gain or loss realized upon its subsequent disposition is to be treated as a capital gain or loss. The IRS states that this case is closer to *Exposition Souvenir* (163 Fed 283) (World's Fair bonds required to be purchased by exhibitor are capital) than cases discussed in Rev. Rul. 58-40. [See page 269.—*Ed.*] Congress intended FNMA to build up its capital by required investment by those it does business with. Marketing fees paid to the Association constitute additional items of mortgage cost in determining the ordinary gain or loss on sale of the mortgage. *Rev. Rul.* 58-41.

Partners transfer business to new corporation and simultaneously sell it patent; sale and amortization on stepped-up basis upheld. Taxpayer corporation was created to take over business of manufacturing television tuners invented by its owner. Simultaneously it purchased his patents and patent applications for a price based on future production and payable in installments. The Commissioner argued that the whole transaction was tax-motivated; that the sale of patents was a fiction; that in reality the patents were contributed to capital; and that taxpayer's basis for amortization of the patents was not the substantial purchase price, but the inventor's basis. The court says there was good business purpose for the incorporation and that, if taxpayer wanted to sell his patents to his corporation, he was free to choose that method. [This transaction occurred in 1950; in 1951 the Code barred capital gain on sales between related taxpayers. —*Ed.*] The court, however, rules in favor of the Commission's contention that amortization deductions cannot be taken on those patents which were issued after the taxable years in question. *Sarkes Tarzian, Inc.*, DC Ind., 2/6/58.

Dividends credited on child's savings account not taxed to parents. Dividends credited by a savings and loan association to an account legally belonging to a minor are taxable to the minor under state law, even though the account is in the name of the parents as trustees. *Rev. Rul.* 58-65.

Corporation denied deduction for payment of bankrupt officer's debt. Taxpayer-corporation held property subject to the indebtedness of its principal stockholder who was adjudged a bankrupt. It paid some $8,000 to the trustee in bankruptcy in partial satisfaction of the indebtedness. The court denies a deduction for the payment; it was a nondeductible capital expenditure incurred to protect its title to the property. *St. Denis Securities Co., Inc.*, TCM 1957-247.

Loss deduction denied for dry well. Taxpayers purchased a strawberry farm. During the negotiations they were told that a certain well on the farm would produce an adequate supply of water. The well went dry, and taxpayers were forced to drill a new well and install a new pump. Taxpayers' claim that the expenditures for the new well and pump were deductible as a casualty loss is denied. There was no indication that the failure of the water supply was occasioned by a drought or some sudden or unusual event. An alternative claim that the items were deductible as a theft loss occasioned by the seller's fraud and misrepresentation is also denied on the grounds that the statement of the adequacy of the existing well amounted to no more than an expression of an opinion rather than a representation of fact. *Springer*, TCM 1957-232.

TAX CONSEQUENCES OF

Corporate organization and distributions

EDITED BY RICHARD L. GREENE, LL.B.

Tax traps and disasters in the ubiquitous and uncoordinated attribution rules

by **M. R. SCHLESINGER**

The various rules scattered throughout the Code under which stock is attributed to (or considered owned by) someone other than the real owner have achieved a certain baleful eminence for providing one of the most disastrous tax traps now gaping wide for the unwary. Unless there is legislation canceling the harm to those caught, we expect to see a large number of cases in coming years in which perfectly sound business planning has resulted in formidable tax liabilities because the planners overlooked some technicality in making their plans. Those areas of tax planning in which attention must be paid to attribution rules were sketched out by Mr. Schlesinger in all-day seminars he held recently, under the auspices of the Ohio State, Cincinnati, Columbus and Cleveland Bar Association.

OVER THE PAST several years, Congress has applied stock and other ownership attribution rules to more and more situations, so that today these rules can crop up in the most unexpected areas. The *Butler* case (*Butler* v. *Patterson*, 148 F. Supp. 197 (D.C.N.D. Ala., 1957)), is a graphic illustration of how disastrously the attribution rules can work.

The taxpayer in the *Butler* case owned only 5% of the stock in the admittedly collapsible corporation. Having less than 10%, he was apparently outside the rule taxing his gain on its sale as ordinary, but through the attribution rules he was held to own 17% and so was subject to the collapsible rules.

This is how it came about. The taxpayer himself (whom we shall call stockholder No. 1) owned only 5% of the stock. However, one of his co-stockholders (whom we shall call stockholder No. 2) owned another 5% of that stock. Stockholder No. 2, was a partner with stockholder No. 1 in another enterprise. For aught that appears, this other enterprise had no relationship whatsoever to the corporation or the corporate business. Suffice it to say, however, that for collapsible corporation purposes there is an attribution rule between partners, with the result that the 5% of stock owned by stockholder No. 2 was attributed to stockholder No. 1, they being partners of each other.

Still another co-stockholder (and we shall call him stockholder No. 3) owned 7% of the stock in the collapsible corporation. Although stockholder No. 3 bore no relationship to stockholder No. 1—no relationship in the family sense and no relationship in the business sense—he was the brother of stockholder No. 2, and the court held that the 7% of the stock owned by stockholder No. 3 should be attributed to stockholder No. 2 because there is an attribution rule as between brothers for this purpose.

As a result, up to this point, we find that No. 2 owns not only his own 5% but also his brother's 7% and he emerges owning 12% of the corporation's stock. No. 2's 12%, however, was then attributed to stockholder No. 1 for the reason, as we have already seen, that No. 2 and No. 1 were partners in another enterprise. No. 1, however, already owned 5% of the stock and when No. 2's 12% of stock (being the 7% that No. 2 did *not* own, as well as the 5% that he did) was added to No. 1's 5% of stock, the result was that No. 1 emerged owning actually, or constructively 17% of the outstanding stock.

Inasmuch as Mr. Butler, therefore, owned more than 10% of the stock in the collapsible corporation, it resulted that his gain on the sale of the stock was taxable at ordinary rates.

The validity of that *Butler* decision is actually very questionable on account of a certain anti-double-attribution rule. Under that rule, under certain situations, stock owned by one person cannot be attributed to a second person and through that second person to a third person because that would be double attribution. That anti-double-attribution rule applies only as between certain relationships, but it does seem that it should have applied in the *Butler* case. Be that as it may, the decision makes the emphatic point for us that these ownership attribution rules do involve hidden dangers.

The rules are ubiquitous

Over a period of years these ownership attribution rules have been spread so as to apply to many situations in which mathematical ownership tests determine tax consequences. The table which appears on page 272 is designed to suggest some of these situations, although in all probability that enumeration is not all-inclusive.

Stock redemption

One of the most important areas in which you should watch your step very carefully is the stock redemption field. Under Section 302 certain mathematical tests are set forth pursuant to which certain corporate redemptions of stock will result in capital gain rather than in ordinary dividend treatment. To be accorded such favorable capital gain treatment, under Section 302, however, a stockholder in general must either have had all of his stock redeemed, or at any rate must wind up after the redemption owning a percentage of the outstanding voting stock which is less than 80% of that percentage which he owned prior to the redemption.

Of importance to us in the present connection is the fact that in applying these mathematical ownership tests, the stockholder whose stock is being re-

deemed will frequently be treated as owning stock by virtue of the ownership attribution rules contained in Section 318.

Personal holding company

A second area in which attribution difficulty is likely to arise is the personal holding company field. As you know, for the prohibitive 85% personal holding company penalty surtax to apply, not more than five individuals must own more than 50% of the corporation's outstanding stock. Now that rule taken alone seems quite simple, but it is complicated by the fact that in determining how much stock these five or less individuals own they are deemed to own not only the stock which they actually own, but also the stock of others pursuant to the prescribed ownership attribution rule.

Finally, we might note that the statute disallows losses and in some cases expenses between a corporation and an individual who owns more than 50% of its stock. Again, in determining the percentage of stock ownership in meeting this test an ownership attribution rule is applied.

Different attribution rules

By referring particularly to those three situations I do not mean to suggest that you should overlook the other areas in which these attribution rules operate. In that connection, you might want to consult the table already referred to.

You should bear in mind that there is no universal set of attribution rules applying to all of these situations. On the contrary, the rules are different for different purposes; this feature, of course, only compounds the complexity. Suppose, to take one example, it is proposed to cut back the percentage of voting common stock owned by a given shareholder in a corporation by redeeming a portion of his stock. At the present time he owns 60% of the outstanding stock and after the proposed redemption, he will own only 47%. As a result, on the face of things, his 60% of stock ownership has been cut back by more than 20% of that percentage. However, a brother of this stockholder owns the balance of the stock in the corporation. Accordingly, if there is attribution of his brother's stock to the 60% stockholder, the result will be that that stockholder will be treated as owning 100% of the stock prior to the redemption and indeed will be treated as still owning 100% of the stock immediately following the redemption. As a result, the favorable 20%-cutback rule will not operate if that attribution operates in this case. You will find, however, that Section 318 sets out the attribution rules for the purposes of meeting the mathematical redemption test under Section 302. Furthermore, peculiarly enough, under 318 there is no attribution of stock ownership as between brothers. As a result, you would give a favorable opinion in the situation which we have imagined.

Now let us take another example. Supposing a corporation owns land. It proposes to sell it at a loss to its 47% stockholder. You will bear in mind that under Section 267(b) such a loss will be disallowed to the corporation only if the purchaser owns more than 50% of the stock in the selling corporation. As we have seen, however, he owns only 47%. Let us assume, however, that the brother of the proposed purchaser owns the other 53%. Now, under Section 267 (c), for the purpose of determining whether the prospective purchaser owns more than 50% of the stock, there is attribution as between brothers, the attribution rule in this connection being quite different from what it is under Section 318 for the purposes of a stock redemption under Section 302.

The moral from these two examples is simply this: having satisfied yourself respecting the attribution rule as it applies to one situation, you can not transpose your findings and your conclusions into a different area. The attribution rules are different for different purposes.

Another observation which we might make respecting the dangers of these rules is the fact that they go beyond attributing stock merely between family members. We have already seen from our examination of the *Butler* case how stock may be attributed as between partners. There is also attribution in other areas, such as between trusts and beneficiaries, and between corporations and substantial stockholders.

These relations can "dangle out in left field," as it were, for there may be no connection between the matter at hand and the relationship which gives rise to the attribution of ownership. We have already seen how that occurred in the *Butler* case where the partnership which resulted in attribution of stock to the taxpaying stockholder presumably had no relationship whatsoever to the corporation or to its business.

This partnership rule, incidentally, involves a trap within a trap, because there can be a partnership in a technical tax sense even though there is no partnership in a general legal sense. There is a definition section, Section 7701, under which a "partnership" includes a common or joint ownership of property held for income and indeed apparently includes such an ownership of property held merely as an investment even though it yields no current income. It would appear, therefore, that when two

SITUATIONS WHERE OWNERSHIP TESTS DETERMINE TAX

Subject	*Principal Section*	*Attribution Section*
Stock redemptions	302	318
Personal holding company stock ownership	542(a)(2) 543(a) (5)&(6)	544
Gains on depreciable property sales between individual and his controlled corporation	1239(a)	1239(a)*
Disallowances of loss, expense and interest deductions between related taxpayers	267(a)&(b)	267 (c)
Hot stock dispositions	306(b)(1)(A)&(B)	318
Stock redemptions by sister corporations	304	318
Collapsible corporation 5% rule	341 (d)(1)	544(a)
Gains on patent sales to corporations substantially owned by seller	1235, 267(b)	267(c)
Kimbell-Diamond basis rule on liquidations of subsidiary corporations	334(b)(3)(C)	318
Limitation on corporate net operating loss carryover where substantial change in stock ownership	382(a)	318
Disallowance of losses between partner and controlled partnership, and between sister partnerships	707(b)	267(c)

* Since operating Section 1239(a) itself sets out the ordinary tax treatment on sales to corporations controlled not only by the seller but also by his family, it cannot be said that the family's stock is "attributed" to the seller. The effect, however, is the same as though the operating section spoke only of the seller's stock ownership, with another section spelling out attribution rules. The subject has been included in the table as a warning, although ultra-technically the statute itself does not speak in terms of attribution.

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persons own vacant property in the hopes of turning it over for profit they are partners in a tax sense even though there is no current income yield.

In that connection, let us turn back to Section 302 and assume that we propose to redeem a portion of a 60% stockholder's voting common stock. We propose to redeem such an amount as will leave him owning only 47% after the redemption. Accordingly, he will own less than 80% of the percentage of stock which he owned prior to the redemption, and the 20%-cutback rule will apparently operate favorably, with the result that there will be no ordinary dividend tax. Suppose, however, that the other stockholder in this enterprise, who owns the other 40% of the stock, is a tenant-in-common with our stockholder in the ownership of some vacant land in California which they hope to sell at a profit. Suppose, to make the example more startling, there is no current income from that land whatsoever. Now no one in his right mind could possibly suggest that these two men are partners in the conventional sense in the ownership of that vacant land; nevertheless, I fear that in the tax sense they are exactly that, and, they being partners, stock owned by the other stockholder is attributed to the stockholder whose shares we propose to redeem. The consequence will be that he starts out owning 100% of the stock and no matter how much of his stock is redeemed he will wind up owning 100% of the stock, with the result that there will not be the required 20% cutback—this is because of the intrusion, the unexpected intrusion, of the ownership attribution rule.

Multiple attribution

Generally there is no double attribution between family members. Suppose, to take an example, that a father's stock is partially redeemed and this father claims that the gain is subject to capital gain rates pursuant to the favorable provision of Section 302 on the grounds that the percentage of voting common stock after redemption is less than 80% of what that percentage was immediately prior to the redemption. Now let us suppose that his daughter also owns some stock. Her stock will be attributed to the father under the attribution rules of Section 318 for determining his percentage of stock ownership both before and after the redemption. Suppose further, however, that this father's son-in-law, being the husband of his daughter, also owns some stock in that corporation. His stock will be attributed to the wife—again under the attribution rule. Observe, however, that the son-in-law's stock will not be reattributed from his wife to her father, the reason being that under Section 318 there is no double attribution as between family members.

We have, then, the possibility of multiple attribution, but with exceptions precluding double attribution in the case of certain relationships. Unfortunately, those anti-double-attribution rules differ as between the various attribution sections. Hence, although double attribution may be prohibited for one purpose, it may be permitted in another area.

Summary

We have seen that the dangers of the attribution rules are rather impressive, particularly in view of their four aspects.

First, we saw that the rules are ubiquitous in that they apply in a number of different areas for a number of different purposes. Second, we saw that different attribution rules may be invoked for different purposes and that there is no universal rule of attribution in all of these various areas. Third, we saw that the rules go far beyond attribution as between family members, and in that connection we saw that the rules might apply because of a relationship having absolutely no connection with the matter at hand. Finally, we saw that to compound these dangers there lurks in the background the stark possibility of multiple attribution; thus, it is possible for there to be attributed to a taxpayer not only the stock of someone who bears some relationship to him but it is actually possible for there to be attributed to him the stock of someone who bears absolutely no relationship to him and indeed a person who is completely unknown to him.

Perhaps the danger can be simply stated: Whenever tax consequences depend upon a mathematical ownership test, then you should be on your guard against the possible intrusion of an ownership attribution rule. ☆

Commissioner wins again in disallowing corporate surtax exemption

THE COMMISSIONER successfully invoked recently Section 15(c) of the 1939 Internal Revenue Code, now Section 1551,[1] in *Theatre Concessions, Inc.,* (1958) 29 TC No. 83. In this case, the taxpayer's parent owned and operated four theaters. Taxpayer was organized by the parent and leased the concession business for a period of five years. The rental was fixed as a percentage of the gross receipts from each concession. There was no change or expansion of the operation of the concessions. The taxpayer contended that the subsidiary was organized: (1) to facilitate a possible sale of the theaters and concessions as separate businesses; (2) to prevent theater managers from knowing total profits and encouraging possible competition; (3) to discourage requests for salary increases by managers; and (4) to insulate theaters' assets from possible damages for sale of poisoned foodstuffs.

The Tax Court summarily rejected these contentions and sustained the Commissioner's disallowance of the $25,000 corporate surtax exemption and the $25,000 minimum excess profits credit. The court noted the taxpayer failed to establish by a clear preponderance of the evidence that the tax savings were not a major purpose of the transaction. The court also had no difficulty in rejecting the contention that the lease was not a "transfer" within Section 15(c).

The only other case we have noted recently in which the Commissioner was successful was *Coastal Oil Storage Company* (1956), 25 TC 1304. "Business purpose" is vital, and any corporation desiring to make a division of an existing business must have strong and compelling business reasons. See 5 JTAX 194,

[1] Sec. 1551 provides: "If any corporation transfers . . . all or part of its property (other than money) to another corporation which was created for the purpose of acquiring such property or which was not actively engaged in business at the time of such acquisition, and if after such transfer the transferor corporation or its stockholders, or both, are in control of such transferee corporation, . . . then such transferee corporation shall not . . . be allowed either the $25,000 exemption from surtax . . . or the $60,000 accumulated earnings credit . . . unless such transferee corporation shall establish by the clear preponderance of the evidence that the securing of such exemption or credit was not a major purpose of such transfer."

October, 1956, for an extensive discussion of the subject.

Theatre Concessions, Inc. should be a warning to tax counselors that action in this area must be carefully planned and well documented. Section 15(c) of the 1939 Code was replaced by Section 1551 of the 1954 Code, and tax men are becoming increasingly aware that it covers now not only the $25,000 corporate exemption but also permits the Commissioner to disallow the $60,000 accumulated earnings credit otherwise granted under Section 535, in absence of a clear preponderance of evidence that the tax motive was not a major purpose for the transfer. Thus, a business purpose is vital to prevent the Section 531 (old Section 102) boom from being lowered in corporate organizations where there is any semblance of a transfer from the old corporation. Moreover, we can see now how easy it is for the court to find a transfer where it can be predicated on a mere leasing arrangement between the parent and subsidiaries. ☆

Needn't report income payments to corporations

FOR A LONG time the Regulations have required persons who pay income to make report of the payment. Payments in excess of $600 in the calendar year which are not reportable on the wage and salary form, W-2, are to be listed on Forms 1096 and 1099. However, except for a few minor exceptions, payments of income to corporations have not been reportable. This is still the rule, despite the statement on the official instruction sheet that accompanies the 1957 corporation income tax form (1120) that income payments to corporations, as well as to individuals, partnerships and fiduciaries, must be reported.

That this statement on the 1120 is an error is shown by the fact that 1096 and 1099 themselves carry the instruction that they are to be used to report payment of income to individuals, partnerships and fiduciaries, with no mention of corporations. ☆

IRS restricting spin-off of branch business

DURING THE three and a half years since the enactment of Section 355 of the 1954 Code, we have observed several times in this Department the grossly restrictive approach of the IRS in limiting the tax free aspects of spin-offs. The discouraging approach was manifested in the Regulations (Section 1.355-1(c)) and in various rulings. We had hoped the spin-off was clearing in 1957 when several favorable rulings were issued (See 6 JTAX 11, January, 1957), but now the Service has released a ruling which will be a serious blow to the plans of many a corporate enterprise looking to a spinoff of a branch plant.

Rev. Rul. 58-54 (1958-8 IRB) imposes a stringent test upon the "active trade or business" requirement of Section 355. The statute requires that the business spin-off and the business retained each have been in active operation for a period of at least five years.

The Ruling notes that Section 355 does not apply to the "division of a single business," and then proceeds to rule that the operation of the same type of business in different states or localities is considered a separate business in each area "only if they are independent of each other." Having adopted this approach, the Service apparently found it simple to hold that a corporation operated an "integrated" business because it manufactured and sold only one product, even though its distribution and sale facilities were in four different towns.

The taxpayer operated a soft drink bottling and distributing business. The bottling was done in the main plant, and the company maintained in four different towns a warehouse for the sale, distribution and storage, where each also sold, rented and serviced coolers in addition to selling and distributing the beverage. Fifty-three per cent of the sales were made in the locality of the main plant and 47% in the three other localities.

The spin-off was defeated in *Rev. Rul.* 58-54 by use of an "integrated business" test and by assuming the same type of business in different states or cities is a separate business only if they are "independent of each other." We cannot say whether the Service was right or wrong in holding that this particular spin-off failed and hence bringing down the dividend axe. We are convinced, however, that if the test is to be whether the plants or stores in various cities or states are "integrated" or are "independent of each other," then few geographical spin-offs will ever pass this stringent requirement.

"Independent" and "integrated" are vague concepts indeed. Who can say, for instance, whether separate retail stores operated in ten different states are independent if they sell a similar line of groceries, but have the same central accounting office, single top management, etc? We hope that the Service will, in administering the spin-off statute in the future, recognize business realities and apply Section 355 so as to permit the carrying out of legitimate business purposes. ☆

New corporate decisions this month

Stockholder-creditor has capital loss on corporate note. Taxpayers transferred three parcels of real estate to a wholly owned corporation in exchange for stock and notes. The real estate had been acquired by taxpayers in foreclosing on their mortgage investments. After the corporation sold the property it was unable to pay the notes. The loss, the court holds, is a capital loss. Taxpayers did not show they were in the real estate business or that the notes were received as an integral part of any business. *Bronsther,* DC N. Y., 1/20/58.

On remand of thin capitalization case Tax Court finds notes were risk capital. Taxpayer and another person made advances to a corporation in which they were each 50% stockholders. The advances were evidenced by demand promissory notes and were roughly in proportion to the stockholdings of the two. The Tax Court disallowed a bad debt deduction for the loans, finding as a fact that the notes did not represent bona fide debts but were really risk capital. The Second Circuit remanded, saying that before it was able to review the decision it must know the basis for the Tax Court's conclusion: it was not sufficient for the Tax Court to find merely the ultimate fact. The opinion of the court, written by Judge Medina, extensively reviewed the form vs. substance and business purpose cases, beginning with *Gregory*. It concluded that the significant factor was whether the funds were advances with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business. In a dissenting opinion, Judge Learned Hand proposed the test of whether the form of invest-

ment chosen by the taxpayer would be upheld for tax purposes: when they decided to make the investment in the form of loans rather than stock, did they suppose the difference would appreciably affect their interests in the venture, other than taxwise? The Tax Court, expressing doubt as to what further action is proper on this remand, makes additional finding of specific ultimate facts: that the advances were placed at the risk of the business, that no outsider would have made such loans. It again disallows the deduction. *Gilbert,* TCM 1958-8.

Business trust taxable as corporation. Taxpayer trust was created by an instrument which provided that the trust could enter into and conduct any imaginable business. Management was centralized in the trustees, who were authorized to appoint a general manager. The instrument also provided for perpetual existence, limited liability, and negotiable certificates of beneficial interest. On the facts the court holds the trust in substance and form to fall within that category of associations taxable as corporations. [The instrument involved was a copyrighted form of the National Pure Trust Association characterized as full of ridiculous high-flown verbiage. The tax at issue here for 1951 was about $750.—*Ed.*]*Elmer Irvin Trust,* 29 TC No. 91.

Advances to real estate corporation to finance purchase were capital. Eight individuals invested $1,000 each in stock of taxpayer real estate corporation. Later that same year each stockholder advanced $9,000 to the corporation in the form of an unsecured loan bearing 7% interest so as to provide it with sufficient funds to acquire property. The alleged advances are held to be contributions to capital, rather than genuine loans, and the interest paid thereon is disallowed. The stated capital of $8,000 was clearly inadequate to finance the purchase of real estate, while the fact that the advances were denominated loans and treated as such on the corporate books was deemed not to be conclusive of their true character. The corporation is denied an interest deduction for interest on the loans. *Northline Realty Corp.,* TCM 1958-21.

Subsidiary too thin; no bad debt deduction. Taxpayer corporation created a subsidiary corporation in 1929 for $300 capital and advanced $63,000 of debt to it for working capital. When it liquidated the subsidiary in 1943, taxpayer claimed a $9,000 bad-debt deduction. The deduction is disallowed. Every factor pointed to the $63,000 being a capital contribution rather than a loan. There was no proof of the existence of the notes. Interest was not paid periodically. Finally, there was a completely disproportionate debt-equity ratio (210/1). *Sunswick Corp.,* DC N. Y., 2/14/58.

Advances to corporations treated as capital contributions. Taxpayer made advances to newly organized corporations which were inadequately capitalized, in order to get the businesses established and to keep them going. There were no notes or other evidences of indebtedness for the advances. The court holds that the amounts were advanced at the risk of the business as capital contributions, rather than loans. A loss from their worthlessness is a capital loss. *Culley,* 29 TC No. 113.

Appreciated property distribution is dividend to extent of realized income, then return of basis, then capital gain. [*Acquiescence*]. In these two cases a corporation with little or no earnings declared a dividend of appreciated property. The Tax Court held that there was a dividend to the extent of earnings and profit; that the fair market value of the property in excess of earnings and profits is a nontaxable return of capital, and that to the extent that the fair market value of the property exceeds the total of earnings and profits and the stockholders' basis it is a capital gain. *Cloutier,* 24 TC 1006, *acq.* IRB 1958-3; prior *non-acq.* CB 1956-2 withdrawn. Similarly *Erburu,* 23 TC 830, *acq.* IRB 1958-3.

Payments to stockholders for unsubstantiated expenses taxed as disguised dividends. A corporation controlled by taxpayer and his wife paid them considerable sums of money and deducted these amounts as travel and entertaining expenses. It also deducted as business expenses sums spent for furnishings, salaries, rents, etc. The court finds from the evidence that some of the payments were proper corporate deductions, but holds, in the absence of adequate substantiation, that most of them were dividends to taxpayer and his wife, and were to be included in their personal income. The statute of limitations is no bar to the assessment of deficiencies and penalties because, the court finds, the returns were fraudulent. *Maloney,* TCM 1958-39.

Parent's capital contribution means failure to meet active business test. In a brief ruling which states the IRS conclusion rather than the reason therefor, the Service holds that a spin-off of a subsidiary stock was taxable as a dividend to the parent's stockholder. The corporate organization was as follows: Taxpayer individual owned two corporations, one an auto dealership and the other a finance company specializing in autos. The dealership also owned all the stock of another auto finance company, which subsidiary was heavily indebted to its parent. The following steps were taken: The dealership forgave the debt of the finance subsidiary and then spun off its stock in the finance subsidiary at a time when the dealership had a substantial earned surplus. Thereafter the individual stockholder caused the two finance companies to merge. The IRS concedes that the forgiveness of the debt was not income to the finance subsidiary. However, the spinning off of the finance-subsidiary stock is a dividend, not a tax-free spin-off under Section 355 because, due to the forgiveness, more than half of the net assets at distribution were not owned in connection with the active conduct of a business for five years. *Rev. Rul.* 58-68.

Costs of derivative suit deductible by corporation. Taxpayer corporation reimbursed a successful stockholder for his expenses in bringing a derivative action. Since a derivative action is presumptively for the benefit of the corporation, the reimbursement is deductible by it. In the related consolidated suit for refund by the stockholder, the court holds the reimbursement was not a dividend to the stockholder. *Ingalls Iron Works,* DC Ala., 1/21/58.

Loss of new subsidiary cannot be carried back against prior year's consolidated income. At issue is the amount of the 1949 consolidated net operating loss which may be carried back against the 1948 consolidated net income. Part of the loss was that of a new subsidiary organized in 1949. Reversing the district court, this court holds the loss of the new subsidiary could not be carried back against income of a taxable year before it came into existence. The court also

holds that the 1947 loss of another subsidiary, incurred before affiliation with the parent, cannot be considered in computing the 1948 consolidated net operating loss deduction. *Houston Oil Field Material Co., Inc.*, CA-5, 2/26/58.

Distributing operation not separate business; spin-off is taxable. A soft drink bottling company distributed its beverages through facilities in different localities. It transferred its distributing operations at three of the locations to three new corporations in return for their capital stock and then distributed the stock to its stockholders on a pro rata basis. The distribution of the stock in the three corporations is held to constitute a dividend. It does not qualify as a tax free divisive reorganization under Section 355 because the operations at the three locations are not considered separate businesses, but part of one integrated enterprise. [See page 274—*Ed.*] *Rev. Rul.* 58-54.

Transfer of properties to controlled corporation a sale rather than a nontaxable exchange. A transfer of properties to a corporation for $50,000 in cash and an installment note of $2,450,000, payable in 49 yearly installments, is held to constitute a taxable sale rather than a tax-free exchange within the meaning of 1939 Code Section 112(b)(5), even though the transferors received stock in the corporation in proportion to their former interests. The conveyance used the language "do hereby grant, sell and convey"; the deferred payments were evidenced by a vendor's lien; and all the parties in interest referred to the transaction as an installment sale. An alternative contention by the transferors that the corporation was inadequately capitalized and that the installment note was not a corporate obligation but represented only a receipt for a capital contribution was rejected. *Shannon,* 29 TC No. 80.

Tax-free incorporation valid though original stock issued on erroneous representation. A partnership transferred its property to taxpayer-corporation solely in exchange for all the outstanding shares upon its representation to the California Corporation Commission that the net value of the assets transferred was $70,000. Later, after more than 20% of the stock had been sold to the public, it was learned that the assets had been overstated. They were given a corrected value of $49,000 and new stock was authorized by the Commission which was exchanged for the old shares. Taxpayer contended the basis of the assets acquired on the exchange was not the same as that of the transferor pursuant to 1939 Code Section 112 (b) (5) because it did not exchange valid stock for the assets, and when the new "corrective" shares were authorized, the transferors were no longer in control of taxpayer. The court disagrees, holding the basis of the assets the same as that of the transferor. Immediately after the exchange the transferor did control over 80% of taxpayer's stock and for purposes of determining control only stock actually issued as of the basic date is considered. The fact that subsequently additional stock was issued to the public for cash or that subsequently new stock was issued in exchange for the original shares did not revoke or rescind the original issue for which the assets were actually exchanged. *Lodi Iron Works, Inc.*, 29 TC No. 79.

Taxpayer sold and mother bought through same investment counsel; loss disallowed. Investment counsel sold certain securities from taxpayer's portfolio to realize short-term losses. On the same day, the investment counsel purchased approximately the same number of shares of these stocks for the mother. The court agrees with the district court and disallows the loss, following *McWilliams* (331 U.S. 694), in which a husband directed his broker to sell certain shares for him and to buy the same issues for his wife. The loss on that sale was disallowed as on a sale between related parties, though in fact the purchases and sales were made to strangers through the ordinary exchange procedure used by everyone. However, the lower court erred in disallowing the loss when 28 days elapsed between the son's sale and the subsequent purchase by the mother. The statute disallowing losses on sales between related parties contains no time limit and has been interpreted as applying to indirect sales which are practically simultaneous and 28 days apart is not simultaneous. *Norton,* CA-5, 1/9/58.

Sale and leaseback of realty upheld; no bargain sale or unreasonable rental. Because taxpayer-corporation's farm implement business required many and continuing financial commitments, it was deemed advisable, from a financial standpoint, to have a separate corporation own a contemplated development of real estate. Taxpayer therefore sold its real estate to a newly formed corporation whose stock was owned by the children of taxpayer's stockholders, and then leased back the property together with other property at a rental based on a percentage of sales. The court finds no "bargain sale" was effected so that taxpayer's stockholders could not have received a taxable dividend distribution as a result of the sale. Furthermore, it finds taxpayer's accrual of rentals for the continued use and possession of the property were not unreasonable but were fully deductible as rental expense. *Southern Ford Tractor Corp.,* 29 TC No. 90.

Key-man self-insurance fund not unreasonable accumulation of surplus. Since its founding more than 50 years ago, taxpayer corporation has followed a very conservative fiscal policy; since 1944 the corporation has been setting aside part of its surplus in a self-insurance fund against key-man disability. The amounts so set aside were determined with reference to commercial policy costs. The court finds there has been no intent to avoid the surtax on the stockholders by the unreasonable accumulation of income. It noted that the dividends the corporation paid bore no relation to fluctuations in the principal stockholder's income. This fact, the court said, showed the absence of the forbidden intent. *Bradford-Robinson Printing Co.,* DC Colo., 12/18/57.

Penalty surtax imposed for unreasonable accumulation. A sand-and-gravel firm owned by two individuals depleted its large accumulation of earnings for 1945 and 1946 through an expansion program carried out in 1947 and 1948. The Tax Court held there was no unreasonable accumulation for the four-year period. But it imposed the Section 102 penalty surtax for the years 1949 to 1952, when working capital was substantially in excess of the annual operating expenses and no valid business purpose was advanced for the accumulation. [The court puts considerable weight on a motion made in 1949 by the minority stockholder that the company did not need the funds and that he had been advised a penalty tax was likely if dividends were not declared.—*Ed.*] The Section 102 penalty was also imposed on a subsidiary, all but four of whose shares

were held by the taxpayer. The Tax Court held the subsidiary failed to prove that the earnings were not accumulated with intent to evade the surtax upon its stockholders. This court affirms both as to the parent and the subsidiary. *Hedberg-Freidheim Contracting Co.*, CA-8, 2/6/58.

Subsidiary's distribution to parent insufficient to satisfy preferred stock; loss on common recognized. Taxpayer-corporation owned all of the common and preferred stock of its subsidiary. On liquidation of the subsidiary, taxpayer received assets insufficient to meet the liquidation rights of the preferred. It claimed a loss on the common despite the provision of 1939 Code Section 112 (b) (6) denying gain or loss on liquidation of a subsidiary. [Same as 1954 Code Section 332.—*Ed.*] A majority of the Tax Court upheld the taxpayer and this court agrees. The non-recognition provisions on the liquidation of a subsidiary will apply only when there is a distribution in liquidation of the common or voting stock. Here the preferred stock claims captured all the assets and there was nothing left to distribute to the parent as a common stockholder in the subsidiary. There is no authority for aggregating the parent's common and preferred stock interests in applying the non-recognition rule. *Spaulding Bakeries, Inc.*, CA-2, 2/26/58.

Cost of stock not basis of assets of purchased corporation (Old Law). In 1951 taxpayer paid $8.5 million for the stock of a corporation the principal asset of which was timber with a basis of $2.5 million. In 1953 taxpayer merged with the purchased corporation. The court instructed the jury that, unless taxpayer purchased the stock with the intent of acquiring the timber, and it retained this intent until the merger, it could not get the stepped-up basis of $8.5 million. The jury found for the government. [Under the 1954 Code the assets of a corporation, liquidated shortly after acquisition of the stock of the corporation, take as their basis the cost of the stock, not the basis in the hands of the old corporation.—*Ed.*] *Georgia-Pacific Corp.*, DC Ga., 1/11/58.

Liquidation loss computed on whole investment, not each share. Taxpayers owned stock purchased at varying prices. When the corporation liquidated in 1952, they were entitled to $10 a share for the stock, $7 immediately and the balance in mortgage notes payable over the next two years. It was conceded the notes were worth face value. They reported a gain on the shares which cost less than $10. They now sue for refund because their total loss on the entire investment was $100,000. The court holds for taxpayer that the stock should be regarded as a block and the $100,000 loss is allowed as a capital loss in 1952. *Palmer*, DC Conn., 2/11/58.

Stockholder has taxable gain on complete liquidation though appreciation was pre-1913 (Old Law). Taxpayer owned stock in a corporation which liquidated in 1952. Most of the distribution in liquidation represented an increase in value of assets prior to 1913, realized thereafter. He argued that, under the 1939 Code, distributions out of pre-1913 earned appreciation were exempt; the district court held, however, that the specific rule taxing liquidations must be applied. This court affirms saying that the rule on liquidations is too plain to be ignored. [The 1954 Code specifically provides that the rules applicable to distributions in general shall not be applied to liquidations.—*Ed.*] *Schaefer*, CA-6, 2/19/58.

Growing hop crop valued. The Tax Court determined the fair market value of a growing hop crop which had been acquired as a liquidating dividend in exchange for stock. This court affirms the Tax Court's finding. *Williams Estate*, CA-9, 1/28/58.

Stockholder-president's salary held reasonable. Taxpayer corporation increased the salary of its president and principal stockholder from $25,000 a year to $75,000 a year. The Commissioner disallowed all but $12,000 of the increase. The court allows the full $75,000 as a deduction. No opinion is reported; however, the facts show there was expert testimony that the salary was reasonable. Moreover, the court found that the reason for the low salary in the preceding years was to make available funds for the expansion of the business. *Rust-Oleum Corp.*, DC Ill., 2/5/58.

No tax benefit from excess depreciation on consolidated loss return. The general rule is that the basis of property must be reduced by depreciation "allowed or allowable," whichever is greater. However, for years through 1952, if the taxpayer makes a proper election, the basis will not be reduced by allowed depreciation in excess of the allowable which resulted in no tax benefit. The IRS here considers the question whether excessive depreciation taken, and therefore allowed, on a consolidated return which showed a net consolidated loss resulted in a tax benefit. If taxpayer had filed a separate return, it would have had taxable income. The Service concludes that, in accordance with the cases on recovery exclusion items, the tax contemplated by the statute is that on the return actually filed. Since in this case the excessive depreciation resulted in no reduction in tax on the return actually filed, there was no benefit and the basis of the property need not be reduced by the excessive amount. *Rev. Rul.* 58-62.

Subsidiaries' losses not attributable to parent. Taxpayers were stockholders of a corporation which made a distribution when it had enough earnings and profits to qualify the distribution as a dividend; however, its subsidiaries had deficits larger than the parent's surplus. The group had filed consolidated returns ever since its formation and the parent had followed the policy of reimbursing the subsidiaries for their losses; they had paid over any profits. The court holds that taxpayer-stockholders received a dividend. That the corporations may be considered as one taxpayer for the purpose of the corporation tax does not affect their individuality for the purpose of determining what is a dividend. The reimbursing of the losses of the subsidiaries by the corporation is an increase in the capital investment of the parent in the subsidiary. *Freedman*, DC Ohio, 1/9/58.

Accounting period of subsidiary must conform to that of parent. The accounting period of a subsidiary corporation which joins in a consolidated return must conform to that of the parent as of the date its income first becomes includible in a consolidated return. Accordingly, if a subsidiary employing an accounting period other than that of the parent files a consent to be included in the consolidated return, the consent acts as an automatic request to the Commissioner that it be permitted to change its accounting period. The taxable income of the subsidiary for the short-period return required to effect the change must be annualized. *Rev. Rul.* 57-602.

NEW DEVELOPMENTS IN

State & local taxation

EDITED BY JOSEPH P. STAPCHINSKAS

Breck and Panhandle; impracticality of judicial standards for interstate taxation

by **JOHN DANE, JR.**

Any lingering doubt that a uniform statutory approach is required to solve the problem of allocation should have been dispelled by two recent judicial decisions involving the question: Panhandle Eastern Pipe and John H. Breck Inc. Mr. Dane analyses these decisions—rendered by the highest courts of Massachusetts and Michigan—to emphasize ineffectiveness of judicial attempts to cope with problem.

IF ALL CORPORATE TAXES were collected by the national government, we should never be faced with the question of how best to apportion the tax payments of a single business organization among the various states in which it operates.

Court pronouncements on the allocation problem can be analyzed from two different points of view. The usual discussion of this subject is directed toward attempting to forecast, on the basis of past decisions, how a particular court will decide on a particular set of facts. Our primary interest, however, is in the general aspects of the allocation problem—how, taking all the states of the Union and all the businesses of the country which operate in more than one state, we can arrive at a method whereby the taxpaying capacity of such corporations may fairly and practically be apportioned among the various states in which they do business.

The purpose of making this analysis is to test the operation of the judicial process as a way out of the allocation quagmire.

The two cases I wish to discuss particularly are *Panhandle Eastern Pipe Line Co.*, 346 Mich. 50, *cert. den.* 352 U.S. 890, and *John H. Breck Inc.*, 1957 Mass. Adv. Sheets 929.

In any given case it is most important to identify the subject of the particular tax in question, the measure of the tax and the rate of the tax. Confusion always arises unless the court distinguishes between the subject of the tax and the measure. For instance, the Supreme Court has struck down a state intangible personal property tax on a corporation's capital and surplus which allowed no deduction for the principal amount of certain United States bonds and accrued interest thereon (*New Jersey Realty Title Insurance Co.*, 338 U.S. 665), but has sustained a franchise tax upon a corporation's net worth which included the value of such securities (*Werner Machine Co., Inc.*, 350 U.S. 492). It was failure to determine correctly the measure of the tax that led, in the *Breck* case, to the reversal of the trial court's decision by the Supreme Judicial Court of Massachusetts.

The Massachusetts corporation excise involved in the *Breck* case is, in the words of Mr. Justice Cutter's opinion, "An excise on the privilege of each domestic business corporation to engage in business based upon its corporate existence (and possession of its corporate franchise) during the taxable year, without regard to whether any business was done."

Thus corporate existence was the subject of the tax. The measure of the tax was in part net income allocable to Massachusetts and in part corporate excess allocable to Massachusetts. The statute provided that certain classes of non-operating income should be allocated to Massachusetts and that the remainder of net income should be allocated on a three-way formula:

1. tangible property in Massachusetts divided by total tangible property times ⅓ of net income.

2. wages and compensation paid in Massachusetts divided by total wages and compensation times ⅓ of net income.

3. gross receipts assignable to Massachusetts divided by total gross receipts times ⅓ of net income.

The sole issue in the case was with respect to the application of the gross receipts fraction. Under the Massachusetts statute, gross receipts are allocated to Massachusetts except in the case of sales "negotiated or effected by agents . . . chiefly situated at, connected with or sent out from premises . . . outside the commonwealth."[1] Acting under this statute, the State Tax Commission, in the *Breck* case, included in the numerator of the sales fraction those sales to out-of-state customers where delivery had been made outside of Massachusetts from stock in Massachusetts. In some cases the salesmen making the sales were residents of Massachusetts; in some they were non-residents. To this action, the taxpayer took exception on the ground that the allocation of net income to Massachusetts by a formula which included in the numerator of the sales fraction gross receipts from sales in interstate commerce violated the Commerce Clause and the Due Process Clause of the Federal Constitution.

The taxpayer relied primarily on *Ford Motor Company*, 308 Mass. 558, which involved the imposition on a foreign corporation of a minimum excise equal to 1/20 of 1% of its gross receipts assignable to Massachusetts. In that case, the court held that the statute could not be applied to bring any interstate business within the Ford company's gross receipts assignable to Massachusetts.

The Appellate Tax Board, following the *Ford* case, held that the interstate sales in question "could not be used as a basis for a tax on gross receipts." The State Tax Commission contended that the Board erred "in having considered the assessment as a direct tax on gross receipts rather than an excise measured by applying the statutory formula . . . to a portion of the net income of" Breck.

[1] Mass. General Laws, Chapter 63, section 38.

In reversing the Board, the Supreme Judicial Court agreed with the State Tax Commission that the tax at issue in the *Breck* case was "not a tax upon or measured by *gross receipts*," and called attention to the fact that, so far as the net income measure was concerned (which was the sole measure at issue in the case), the tax would be zero unless the corporation had net income. It distinguished the *Ford* case, *supra*, by pointing out that in that case gross receipts assignable to Massachusetts were used directly as the measure of the excise rather than as a means of allocating net income as was the situation in the *Breck* case.

After an extended analysis of the relevant decisions of the Supreme Court of the United States, the court held, in the *Breck* case, that no violation of either the Commerce Clause or the Due Process Clause resulted from the use of the interstate sales in question in the apportionment of net income taxable in Massachusetts. The court found it permissible under the Commerce Clause, in the imposition of a tax on a domestic corporation for possessing or exercising its corporate privileges, to measure the tax by net income apportioned in a practical but not necessarily precise way so as to give a reasonable and rough approximation of values attributable to the taxing state granting the privileges. The court found it immaterial that net income from interstate transactions (and the value given to intrastate privileges by them) may be taken into account reasonably in the tax computations.

The court went on to consider the taxpayer's further contention that the aggregate effect of the tax, as assessed by the Commission, was so unreasonable that it operated to reach profits in no just sense attributable to transactions within the jurisdiction of Massachusetts. The court disposed of this point by saying that the elimination of the disputed sales in question would have reduced the allocation percentage from 71% to 57% and that no evidence had been introduced by the taxpayer to prove that an allocation to Massachusetts of 71% of net income necessarily resulted in over-valuation by fourteen percentage points of the aggregate intrastate privileges subject to tax.

Finally, the court discussed the taxpayer's contention that the Commission's allocation involved the risk of double taxation of the same sales because, under decisions of the Supreme Court, New York could impose taxes upon the sale or use of the goods in question. The court found an easy answer to this, namely, that the tax before it was not a sales or use tax but an excise on corporate privileges based on a net income measure designed to reflect solely Massachusetts values, and that no other state could impose a tax on those privileges or values. The court went on to say that, if any other state should impose an excise on Breck for doing business in such other state with the result of a minor overlapping of measures of net income. this would be at most "an inconsequential result of the 'honest state efforts to make apportionments' . . . intended to reach a fair approximation of the value of the respective privileges subject to tax. Any inaccuracy would be well within the limits of action permitted to the states."

While these last two points raised by Justice Cutter's opinion in the *Breck* case took up only a small fraction of the total length of the opinion, they are, from the point of view of the practical businessman, even if not from that of the constitutional lawyer, of the very greatest importance and I plan to return to a further discussion of them after a brief analysis of the other recent case on this subject.

Panhandle Eastern Pipe Line

In the second case considered, the *Panhandle Eastern Pipe Line* case, *supra*, the Supreme Court of Michigan nowhere in its opinion gives us any clearcut statement of what the subject of the tax is, but an analysis of the statute indicates that the subject of the tax was the privilege of engaging in intrastate commerce. The measure of the tax was the paid-up capital and surplus attributable to Michigan determined by the application of a Massachusetts-type three-factor formula based on property, payroll and sales. As in the *Breck* case, the dispute arose with respect to the sales factor of the formula since the Michigan law required that 50% of sales of goods brought in from out of state and sold in Michigan was to be included in the numerator of this factor.

The taxpayer, the Panhandle Eastern Pipe Line Co., was a foreign corporation engaged in the production, purchase, transportation and sale of natural gas. It sold gas in Michigan at wholesale. Only about 6% of the total gas sales which Panhandle made in Michigan were of gas produced in that state. The balance of the gas sold was produced or purchased elsewhere, mainly in Texas, Oklahoma and Kansas.

The Supreme Court of Michigan held that the tax violated the Commerce Clause. Sales of gas brought into Michigan from other states, 50% of which was included in the numerator of the sales factor, were interstate sales and to include any part of them in the formula would constitute an invalid tax on interstate commerce. In the court's view, the sales of gas produced in Michigan could be separated from the sales of gas brought in from other states. Such interstate business was, the court felt, completely severable and unrelated to its intrastate business.

Let us stop now for a moment and compare *Panhandle* with *Breck*. In *Breck*, the court specifically found that the tax was "on the privilege of each domestic corporation to engage in business based upon its corporate existence (and possession of its corporate franchise) during the taxable year, without regard to any business done." In *Panhandle*, the court nowhere states just what it considers the subject of the tax to be and this failure has, I submit, led the Michigan court into exactly the same error that the Appellate Tax Board fell into in *Breck*. Each of these tribunals assumed that the interstate sales in question were being used as a measure of the tax. This was not the case. In *Breck*, net income was the measure of the tax and interstate sales were used merely in the allocation of such net income. In *Panhandle*, paid-up capital and surplus was the measure of the tax, and the interstate sales were used solely to determine the portion of such capital and surplus which was allocable to Michigan.

Limitations of judicial approach

The foregoing analysis of the *Breck* and *Panhandle* cases indicates the limitations of the judicial approach to the allocation problem. All that the courts do is to decide whether or not a particular allocation formula provided for in a statute violates the Commerce Clause of the Federal Constitution. If the court finds, as it did in the *Ford* case, that the

[*John Dane, Jr., is Associate Commissioner of Corporations and Taxation of the Commonwealth of Massachusetts. This article is based on a paper written for the Forty-fifth Annual Conference on Taxation of the New England State Tax Officials Association.*]

tax, even though imposed on a proper subject—the right to do intrastate commerce—is measured by interstate sales, it must strike down the tax as an improper burden on interstate commerce. If, on the other hand, interstate sales are used merely in the allocation of net income—net income being the measure of the tax—no violation of the Commerce Clause necessarily exists.

The vice of the Commerce Clause approach is that it sees everything all black or all white. Such an approach may be all very well in a field such as that of the constitutional right of an individual to vote, but it does not make much sense in the area of taxation of business enterprises. To say that a state may not, under the Commerce Clause, impose a franchise tax measured by net income on a corporation engaged solely in interstate commerce within its borders, as in *Spector Motor Service, Inc.*, 340 U.S. 602, but that it may impose an income tax under the same circumstances, as in *West Publishing Co.*, 328 U.S. 823, may be satisfying to constitutional lawyers, but it is thoroughly frustrating to practical tax administrators and practical businessmen. To such practical men, the question does not frame itself in absolutes. The pertinent question to them is not, "Does this tax impose an unconstitutional burden on interstate commerce?" They tend to think of it more in this light—corporation X does business in states A, B and C. Assuming that it has a certain taxpaying potential, how should this be most equitably divided among these states.

This question could, to a certain extent, be answered by reference to the Due Process Clause of the Federal Constitution. The question—is a statutory method of allocation so arbitrary as to amount to deprivation of property without due process of law?—is certainly a meaningful one. James E. Sabine, Assistant Attorney General of California, took this approach when he recently said:

"In the *Panhandle* case, it would seem that, instead of in effect holding that inclusion in the formula of 50% of the interstate sales would constitute an invalid tax on interstate commerce, the Michigan Supreme Court should have directed its attention to whether including 50% of the interstate sales in the formula was unreasonable as a matter of due process of law and would allocate more property value to Michigan than was reasonably attributable to that state."

The trouble is that courts do not usually care to decide questions of degree when they can answer questions of kind. They would prefer to confine themselves to saying that a tax is, or is not, a burden on interstate commerce, rather than saying that, taking all factors into consideration, a particular allocation violates due process. The question of where to draw the line is always a difficult one.

In the *Breck* case, the taxpayer urged that the action of the State Tax Commission violated both the Commerce Clause and the Due Process Clause. The applicability of the Due Process Clause was dealt with by the court in the following footnote:

"Only questions with respect to the effect of the excise here involved upon interstate commerce have been seriously argued. The Appellate Tax Board did not deal with any question of due process. The cases which seem controlling on the interstate commerce issue seem also to control any question which might be raised on the issue of due process."

However, in the closing paragraphs of its opinion in the *Breck* case, the court in substance concerned itself with due process problems when it stated:

"There are no findings of fact by the Appellate Tax Board and no evidence on which could be based a ruling that an allocation to Massachusetts of 71% of net income (as required by the total effect of the statutory formula, which must be viewed as a whole) necessarily resulted in over-valuation, by fourteen percentage points, of the aggregate intrastate privileges . . . subjected to tax."

One wonders how the opinion of the court would have read if the difference in allocating percentage had been, not 14, but 50 percentage points.

No criticism intended

The foregoing is not to be construed as a criticism of the role which the courts have played in allocation cases. They have answered the questions which have been put to them. These have been constitutional questions and the questioners have received back constitutional answers. If the courts have preferred the relative certainty of the Commerce Clause to the uncertainty of due process, they can hardly be blamed for this. A fault may lie in phrasing a decision in terms of the Commerce Clause when in reality their basic criteria of decision have had a closer relation to due process. There has been a basic reluctance to pin the due process tail on this particular tax donkey. But the point is that the basic question is not whether a particular allocation violates a particular constitutional provision, but rather what is the fairest over-all method of allocation. Tax administrators, taken as a group, want to be sure that all the taxable base of a given corporation is taxed in one state or another. Corporate managers want to be sure that they are not taxed in two different states on the same tax base.

The allocation problem cannot be solved merely by having courts decide in particular cases whether or not some constitutional provision has been violated. An over-all attempt must be made to secure efficiency and equity in taxation. But, you ask, how can this be achieved. A very practical answer to this question has been given by Mr. Jerome R. Hellerstein [5 JTAX 303, November 1956]. He points out that Congress has ample power under the Commerce Clause to deal with the problem of state taxation of interstate commerce. This power has been exercised in the field of unemployment insurance taxes, where Congress has authorized the states to apply these taxes equally to local and interstate business, something which the states could not have done in the absence of such authorization. Another example of such Congressional authorization is the legislation facilitating collection of state taxes on interstate shipments of cigarettes.

The essence of Mr. Hellerstein's suggestion is as follows:

"Congress could, for example, establish an administrative agency charged with the duty of promulgating uniform allocation formulae and methods; the legislation could provide that no state may impose certain specified levies on a business engaged partially or wholly in interstate commerce, unless it adopts the allocation methods prescribed by the administrative agency . . . .

"Congress would not dictate the types of levies or rates of tax to be imposed, but it would, through an expert agency, prescribe uniform allocation methods for similar taxes or perhaps designate a single state for the imposition of specified types of taxes which the states would be bound to apply if they sought to tax interstate businesses."

Perhaps, by holding out to the states the tempting bait of being able to collect a tax on hitherto exempt interstate transactions, the adoption of a uniform allocation statute can be hastened. ☆

New state & local decisions

Penn. Franchise Tax upheld on out-of-state assets. Pennsylvania's franchise tax, measured by capital stock, is imposed on the privilege of doing business in the state with the value of the latter determined on the basis of a three-factor formula: assets, payroll and sales. The court holds that out-of-state assets are properly includible in the tax base of a foreign corporation. The taxpayer contended that the tax was a property tax and that therefore extra-territorial assets could not be included in arriving at the taxable valuation. The court, however, held that the franchise tax was not a property tax but an excise tax on the privilege of doing business in Pennsylvania and that the incidence of the tax was upon the value of the franchise and not upon the property itself. *National Biscuit Co.,* Sp. Ct. Penn., 11/11/57.

Utility Franchise Tax invalid. The New Hampshire tax on the value of the franchise of electric power companies has been held unconstitutional. The essential point of the court's opinion was that the statute, in effect, required earnings available for common stock to be capitalized at the rate which the utility is permitted to earn on all its property. This, the court said, would result in a confiscatory assessment. Even though the tax commission did not use this method of valuing the franchise, the court said it was the one required by the statute and no other method of valuation could be substituted for it. Lacking a standard of valuation, the whole statute is void and no tax may be levied under its provisions. *Public Service Co.,* Sp. Ct. N. H., 11/26/57.

Tax by state of negotiation upheld. Taxpayer's local sales office contacted prospective customers, accepted the orders giving final approval, forwarded the orders to the manufacturer for confirmation and handled the billing and collections. The taxpayer obtained about 75% of the products it sold from other manufacturers outside the state. Most of the goods were priced at the place of manufacture and shipped f.o.b. direct to the purchaser under purchase contracts which passed title to the buyers at the place of shipment. In ruling that the gross proceeds of the local sales office were subject to the Washington tax on gross proceeds, the court held that there was no question of apportionment since no part of the tax was on manufacturing or other out-of-state activities. Since the sales were negotiated in Washington, the court said, the fact that delivery was made direct to the purchaser did not change the nature of the local transaction. *U. S. Steel,* Sp. Ct. Wash., 10/31/57.

Use tax on U. S. contractor upheld. A contractor doing construction work for the United States on a Federal reservation was required to furnish the necessary materials. Title to the materials or to the work in which the materials were incorporated passed to the Federal Government after approval by its representative and after full or partial payment had been made to the contractor. Material and workmanship rejected by the Government had to be replaced or redone by the contractor at his own expense. The court held that under the contract the contractor and not the Government became the owner of the materials, since the latter was not required to pay for them until after their installation and could not deny payment if the installation did not meet specifications. It ruled, therefore, that the use tax on materials purchased out-of-state for use in such construction did not fall on Government property but was a valid imposition on the contractor. *McKee,* Sp. Ct. N. Mex., 9/23/57.

Sales tax on some food sales to military. An Illinois taxpayer sold foodstuffs to the Federal Government which were utilized in three different ways. Some were prepared in mess halls operated by the military establishment to feed noncommissioned officers and enlisted personnel. Some were prepared in mess halls in which commissioned officers and civilian employees were fed. Some were sold to post exchanges. Taxpayer contended that it was not subject to the Illinois Retailers' Occupation (sales) Tax on the ground that the transactions were not sales at retail since the food was resold to armed forces personnel for a valuable consideration. The court upheld the taxpayer's contention with respect to food used by the Government post exchanges and in the commissioned officers' and civilian employees' mess hall since the former resold the food and the latter charged for the meals served. It construed sales of food used in enlisted men's mess halls to be taxable retail sales, however, since the food here was served at Government expense without charge to the recipients. *Beatrice Foods Co.,* Sp. Ct. Ill., 11/20/57.

Maryland puts sales tax on labor charges

A NEW regulation added to the Maryland sales and use tax acts provides that the tax be charged on the full selling price for the production or fabrication of tangible personal property on special orders even though charges for labor are segregated from the cost of materials. Applicable to the production of any new items, the rule applies with equal force to those situations where the materials are furnished by the customer and the fabrication consists wholly of labor. Examples are: services performed by a steel fabricator or machine shop performing services on materials furnished by the customer; a tailor making a suit from materials furnished by the customer; and the making of draperies and slipcovers from materials furnished by the customer.

The test applied under the regulation is this: if the labor is expended in producing a new item, it is subject to the tax. If the labor is expended in repairing or altering existing property belonging to another to restore the item to its original condition or usefulness, the tax does not apply to the labor. ☆

Colorado ends installment payments of income tax

COLORADO HAS repealed a provision allowing taxpayers to pay income taxes in four equal installments. Under the new law, beginning with tax years ending on or after December 31, 1957, taxes must be paid in full on the fifteenth day of the fourth month following the close of the taxable year. Colorado, in 1955, provided for the withholding of income taxes from salaries and wages. ☆

The reports here on significant new state tax decisions are provided through the cooperation of the Federation of Tax Administrators. They are adapted from Tax Administrators News.

THE TAXATION OF INDIVIDUALS

Personal tax problems

EDITED BY BENJAMIN HARROW, J.D., CPA

What to do about expense accounts now that IRS has issued new rules

THE IRS has come up with what must be considered a reasonable solution to the furor over deductibility of travel and entertainment expenses. Essentially, the new proposed regulations don't change the rules much; the net result is that most taxpayers will do about what they had been doing before the storm over line 6(a) arose last autumn.

One great virtue of the new regulation is that it clears the air. It removes the old, but not-enforced, rule that receipts by the taxpayer in respect of such expenses had to be reported on Form 1040. In specifying what must be and what need not be reported, the Service will make everyone's life easier.

Two points need to be emphasized. The new regulations reestablish with a new clarity and vigor the basic principles of accounting and tax law which have governed handling of expense accounts. The advice of lawyers and accountants offered during the confused period continues to be a correct and workable guide to taxpayers. [A reprint pamphlet of the principal articles and cases on this subject has recently been compiled by The Journal of Taxation and published as No. 5 in the Practitioner's Guide Series. It is available for $2 per copy from The Journal office. It is 68 pages plus cover, 6 x 9 inches.]

The second point is that some of the language in the proposed regulations is not as clear as it might be. Paragraph 19.1-2 says: "The employee need not report . . . expenses . . . incurred by an employee solely for the benefit of the employer for which he accounts to his employer and which are charged directly or indirectly to the employer or for which the employee is paid . . . ."

Paragraph 19.1-3, covering expenses for which the employee does not have to account to his employer, says: "The taxpayer must submit the following information on his tax return in connection with expenses for travel, transportation, entertainment, and similar purposes incurred by an employee for which he does not account to his employer, and which are paid or incurred by the employee under a reimbursement or other expense allowance arrangement with his employer or are otherwise charged directly or indirectly to his employer . . . ."

The language of these two paragraphs, the first of which requires reporting and the second of which does not require reporting, are so similar as to be confusing. In 19.1-3 use of the word "reimbursement" certainly sounds as though it were a conventional expense-account arrangement, not the "flat allowance" type which seems clearly to be the target of this paragraph. Apparently the distinction turns on the detail of reporting to the employer; if expenses are itemized to the employer, they need not be reported; if not itemized, then they must be reported.

Area for caution

Nothing in the new regulations weakens the right of the IRS to ask for proof of any deduction. It still remains as clear as it has always been that the IRS is interested in those taxpayers whose affairs are such that they could very easily cheat on their expense accounts. This applies particularly to proprietors and owners of controlled corporations, certain occupational groups, and those who get flat allowances for expenses. In taking the heat off the small taxpayer, the IRS is at the same time concentrating its attention on the suspect or vulnerable taxpayers. This should be a warning to all taxpayers in the suspect groups and their tax advisers.

Text of regulation printed

Because the new regulations affect so many taxpayers, we are printing the text verbatim in the accompanying box. ☆

PROPOSED REGULATION

"19.1-1 *Introductory.* The purpose of the regulations under this part is to provide rules for the reporting of information on income tax returns by taxpayers who pay or incur trade or business expenses in connection with the performance of services as an employee and to furnish guidance as to the type of records which will be useful in compiling such information and in its substantiation, if required. The rules prescribed in this regulation do not apply to expenses incurred for incidentals, such as office supplies for the employer or local transportation in connection with an errand. Employees incurring such incidental expenses are not required to provide substantiation for such amounts.

"19.1-2 *Expenses for which the employee does account to his employer.* (a) The employee need not report on his tax return (either itemized or in totaled amount) expenses for travel, transportation, entertainment and similar purposes incurred by an employee solely for the benefit of the employer for which he accounts to his employer and which are charged directly or indirectly to the employer or for which the employee is paid through advances, reimbursements, or otherwise. The taxpayer must state in the return that the amounts charged to the employer (directly or indirectly) or received from the employer as advances or reimbursements did not exceed the ordinary and necessary business expenses paid or incurred by the employee. In case the total did exceed such expenses the taxpayer must state on the return that the excess has been included in income.

"(b) To 'account to his employer' as used in this section means to submit an expense account or other required written statement to the employer showing the business nature and the amount of the employee's expenses broken down into such broad categories as transportation, meals and lodging while away from home overnight, entertainment expenses, and other business expenses. For this purpose, the Commissioner in his discretion may approve reasonable business practices under which mileage, per diem in lieu of subsistence, and

similar allowances providing for ordinary and necessary business expenses in accordance with a fixed scale may be regarded as equivalent to an accounting to the employer.

"19.1-3 *Expenses for which the employee does not have to account to his employer.* The taxpayer must submit the following information on his tax return in connection with expenses for travel, transportation, entertainment, and similar purposes incurred by an employee for which he does not account to his employer, and which are paid or incurred by the employee under a reimbursement or other expense allowance arrangement with his employer or are otherwise charged directly or indirectly to his employer (or if not so paid, incurred or charged, are claimed as deductions on the employee's return):

"(a) The total of any such charges paid or borne by the employer and of any other amounts received from the employer for payment of expenses whether by means of advances, reimbursements, or otherwise, and

"(b) A statement showing the nature of his occupation; the number of days away from home on business; and the amount of such expenses as constitute ordinary and necessary business expenses (including those charged directly or indirectly to the employer) broken down into such broad categories as transportation, meals and lodging while away from home overnight, entertainment expenses, and other business expenses.

"19.1-4 *Substantiation of items of expense.* (a) Although the Commissioner may require any taxpayer to substantiate such information concerning expense accounts as may appear to be pertinent in determining tax liability, taxpayers ordinarily will not be called upon to substantiate expense account information except in the case of expenses for which the employee does not have to account to his employer.

"(b) One method for substantiating expenses incurred by an employee in connection with his employment is through the preparation of a daily diary or record of expenditures, maintained in sufficient detail to enable him readily to identify the amount and nature of any expenditure, and the preservation of supporting documents, especially in connection with large or exceptional expenditures. Nevertheless, it is recognized that, by reason of the nature of certain expenses or the circumstances under which they are incurred, it is often difficult for an employee to maintain completely detailed records or to preserve supporting documents for all his expenses.

Detailed records of small expenditures incurred in traveling or for transportation, as for example, tips, will not be required.

"(c) Where records are incomplete or documentary proof is unavailable, it may be possible to establish the amount of the expenditures by approximations based upon reliable secondary sources of information and collateral evidence. For example, in connection with an item of traveling expense a taxpayer might establish that he was in a travel status a certain number of days but that it was impracticable for him to establish the details of all his various items of travel expense. In such a case rail fares or plane fares can usually be ascertained with exactness and automobile costs approximated on the basis of mileage covered. A reasonable approximation of meals and lodging might be based upon receipted hotel bills or upon average daily rates for such accommodations and meals prevailing in the particular community for comparable accommodations. Since detailed records of incidental items are not required, deductions for these items may be based upon a reasonable approximation. In connection with the determination of factual matters of this type, due consideration will be given to the reasonableness of the stated expenditures for the claimed purposes in relation to the taxpayer's circumstances (such as his income and the nature of his occupation), to the reliability and accuracy of records in connection with other items more readily lending themselves to detailed record-keeping, and to all of the facts in the particular case.

"19.1-5 *Prior regulations.* The provisions of the regulations in this part are supplemental to existing regulations relating to information required to be submitted with income tax returns, and shall be applicable with respect to taxable years beginning after December 31, 1957, notwithstanding any existing regulation to the contrary."

Stockholder's derivative suit expenses deductible

SINCE OUR publication of the article on deductibility of expenses in connection with proxy fights, derivative suits, etc. (7 JTAX 362), two interesting developments have occurred: (1) the *Shoe Corp.* decision (29 TC No. 33) holding that expenses incurred by a stockholder in a successful derivative suit and reimbursed to him by the corporation are deductible to the corporation, and (2) a correction of an implication that one ruling mentioned was obtained by L. D. Gilbert.

In *Shoe Corp.*, the corporation was allowed a deduction for attorney and accountant fees incurred by a shareholder in prosecuting a successful derivative action against the corporation and reimbursed to the stockholder by the corporation as part of the judgment. The Tax Court there stated that, had the shareholder borne these expenses, he could have deducted them under the nonbusiness expense provisions as an ordinary and necessary expense for the protection of his investment. The derivative action sought to enjoin the issuance of Class B shares which would diminish the value and rights of the shareholder's Class A shares. Of course, the Tax Court did not have before it the case of a stockholder-taxpayer who had borne such expenses, but if the Tax Court's statement means that in such case it would hold that the shareholder could have taken the deduction paid by him, we will have an inequitable rule. A shareholder could deduct expenses incurred in stopping the issuance through a derivative suit, but the Revenue Ruling, mentioned above, would deny deduction of expenses incurred in stopping the issuance through the more usual method of attending and taking an active part in the shareholders' meeting called to approve the issue.

The earlier article said that ". . . a recent Revenue Ruling disallowed any deduction for travel expenses incurred in attending stockholders' meetings . . .". Footnote 1 referred to this Ruling and said *"Rev. Rul.* 56-511 . . . The situation giving rise to this Ruling involved L. D. Gilbert, famous 'professional stockholder.' This fact may have played a large part in the Ruling and its reasoning."

Mr. Gilbert has asked the authors of the article to report that the Ruling was not made on the application of Mr. Gilbert or by anyone on his behalf. ☆

Proposed tax cuts: who benefits and how much under plans currently proposed

SENTIMENT IN CONGRESS grows for an immediate tax cut. And, of course, as soon as there seems to be a chance of passage of a cut, all kinds of schemes for doing it are proposed—split the first bracket, increase personal exemptions with or without changes in dependency allowances, apply an across-the-board percentage cut and, this time, one that seems to be a new idea, cut the withholding percentage for a fixed period and adjust the annual rate to coincide. The staff of the Joint Committee on Internal Revenue Taxation (Colin F. Stam, chief of staff) analyzed revenue losses which might be expected from 18 proposals of this kind—the total revenue reduction each would effect and how that reduction would be distributed among the various tax brackets.

Quickie cut in withholding

This suggestion would reduce the withholding rate from 18% to 9% for a 6-month period beginning July 1, 1958. It also provides for an accompanying adjustment in the final liability. Such a plan would increase the purchasing power of wage earners by about $1.2 billion a month. In the case of taxpayers not subject to withholding, adjustments could be made in their declarations.

This plan could be extended for a longer period if economic conditions warranted. Table I indicates the reduction of withheld taxes under various salary levels and exemption classes.

Plans changing exemptions

Increasing the present $600 per capita exemptions to $700 would relieve 4,200,000 taxpayers from all income-tax liability. Line (a) of Table II shows the estimated distribution of the tax reduction under this plan.

Increasing the present $600 per capita exemptions to $650 and in addition providing for a 5% reduction in tax would relieve 2,100,000 taxpayers from all tax liability. Line (b) of Table II shows the estimated distribution of reduction.

Another plan, shown on line (c) of Table II, would provide a $20 tax credit for each personal and dependency exemption claimed by the taxpayer. An estimated 4,200,000 taxpayers would be relieved of all tax liability.

Another plan (Table II, line (d)) would provide a tax credit of $140 for each exemption claimed by the taxpayer in lieu of the present deduction of $600 for each exemption. For taxpayers in the first income-tax bracket the $140 tax credit would result in a tax saving of $20 more per exemption. In addition this plan would allow a reduction of one percentage point in the tax rate on the first $2,000 of taxable income and three percentage points in all other rates. This three-percentage-point reduction above the first income-tax bracket is suggested to compensate for and give relief to those taxpayers whose benefit by way of the conversion of the exemption into a tax credit has been taken away.

Changes in rates

A reduction of the present-law rates in all brackets by two percentage points would have the effect indicated on line (e) of Table II. A 10% reduction in tax (Table II, line f) could be incorporated into the tax table so as not to make necessary a separate computation by the taxpayer.

Another variation, shown at line (g) of Table II, would provide a 10% reduction in tax on the first $2,000 of taxable income and 5% reduction in the tax on taxable income over $2,000.

Table I

Reduction in Withheld Taxes

Weekly Earnings	6-mo. Earnings	6-mo. Reduction in Withheld Tax 1 ex.	2 ex.	3 ex.
$ 50	$1,300	$ 87	$ 56	*
75	1,950	145	115	$ 54
100	2,600	204	173	112
125	3,250	262	232	171
150	3,900	321	290	229
175	4,550	379	349	288
200	5,200	438	407	346

*No withholding under present law.

These percentages could be worked into the rate schedule to eliminate the necessity of the taxpayer's making extra computations.

A plan that would take longer to achieve its effect would provide a tax reduction in approximately five equal stages over a period of from five to nine years. The individual rates would be reduced from a top rate of 91% to 42% and the starting rate from 20% to 15%. The revenue loss from the reduction in the individual rates is shown in Table III.

Split the first bracket

One proposal would split the first $2,000 taxable income class into two classes of $1,000 each and provide a rate of 10% on the first $1,000 and leave the present 20% rate on the next $1,000. Except for married couples filing joint returns, the tax for those with taxable incomes over $1,000 would be reduced

Table II

Amount and Distribution of Decrease Under Alternative Plans

	INCOME CLASS Under $5,000		$5,000-10,000		Over $10,000	
	A[1]	B[2]	A[1]	B[2]	A[1]	B[2]
Plan a	$1,092	39.5	$1,306	47.3	$ 366	13.2
Plan b	901	28.7	1,311	41.8	928	29.5
Plan c	1,083	42.6	1,220	48.0	240	9.4
Plan d	1,764	35.0	2,419	48.0	856	17.0
Plan e	738	23.6	1,386	44.4	999	32.0
Plan f	742	20.3	1,413	38.6	1,504	41.1
Plan g	715	25.3	1,278	45.3	831	29.4
Plan h	2,802	40.3	3,481	50.1	670	9.6
Plan i	651	25.8	1,055	41.8	819	32.4
Plan j	1,107	28.1	1,925	48.8	913	23.1
Plan k	648	36.9	864	49.3	242	13.8
Plan l	1,207	45.3	706	26.5	752	28.2
Plan m	987	28.2	1,527	43.7	982	28.1
Plan n	1,407	35.9	1,527	39.0	982	25.1

1—Millions of dollars of decrease. 2—Percentage distribution of decrease.

Table III

Initial and Total Reduction in Tax

Income Class	Millions of Dollars First Year	Full Effect	Percentage Distribution First Year	Full Effect
Under $5,000	$ 380	$1,888	16.5	16.4
$5,000 to $10,000	750	3,614	32.6	31.5
Over $10,000	1,172	5,989	50.9	52.1
Total	$2,302	$11,491		

by $100. In the case of married couples filing joint returns, the reduction because of split income would amount to $200 where their taxable income exceeds $2,000. The estimated distribution of reduction under this plan is shown in line (h) of Table II.

Line (i) of Table II shows a variation on this that would split the first $2,000 tax bracket with a tax rate of 18% on the first $1,000 of taxable income and in addition provide a 5% reduction in all other tax rates.

Allow earned income credit

A tax credit of 3% has been proposed on taxable income considered as earned. All income under $5,000 is considered earned. Apart from this limitation, earned income would be defined as now provided for in Section 911(b) of the Internal Revenue Code of 1954. This section defines earned income for the exemption of income earned abroad. It says earned income means wages, salaries or professional fees and the amounts received as compensation for personal services actually rendered. Line (j) of Table II shows the distribution of reduction under this plan.

Changing the standard deduction

A relatively small total cut would result from an increase of the present 10% optional standard deduction to 15% and an increase of the maximum standard deduction from $1,000 to $1,500. See line (k), Table II.

A variation provides a minimum standard deduction of $500. Under present law a taxpayer may elect the optional standard deduction of approximately 10% of his adjusted gross income. A taxpayer with a salary of $5,000 receives a standard deduction of $500 under present law and this would remain the same under the plan. For incomes above $5,000 this plan would provide no relief. 3,900,000 taxpayers would be relieved of all tax liability and the plan would result in a revenue loss of $880 million with the entire amount of this reduction going to taxpayers under $5,000.

Table II, line (l) shows still another variant which would provide a minimum standard deduction of $500 and in addition give all taxpayers a 5% reduction in tax. At a salary of $5,000 and above no benefit would be received from the minimum standard deduction, but these taxpayers would receive the 5% reduction in tax. 3,900,000 taxpayers would be relieved of all tax liability under this plan.

Another proposal, shown at line (m), Table II, would increase the 10% optional standard deduction to 15% and raise the maximum standard deduction from $1,000 to $1,500. In addition there would be a 5% reduction in the tax payable.

Line (n), Table II shows an elaboration which would increase the present 10% optional standard deduction to 15% and raise the maximum limitation from $1,000 to $1,500 with the proviso that each taxpayer would receive at least a minimum standard deduction of $500. In addition there would be a 5% reduction in the tax payable. This would relieve an estimated 3,900,000 taxpayers of all tax liability. ☆

A consoling thought for April 16: it might have been, it has been, worse

by **LEOPOLD KOHR**

While we were in the throes of putting together our own tax return and figuring out the horrendous total, we received the following fascinating paper which cheered us mightily. We recommend that when you are angriest about the manifest inequity of taxing you so highly, you read this little discourse on tax collections in antiquity. Mr. Kohr is Associate Professor of Economics and Public Administration at the College of Social Sciences at the University of Puerto Rico.

WE REALLY SHOULD not complain; both taxes and tax collecting methods could be worse. Let us only look at the practices of some of the fund-hungry governments of antiquity. A report compiled (perhaps upon request of some Un-Athenian Tax Practices Committee) by the students of a Seminar in Public Finance under the supervision of Aristotle of Stagira (Academy of Athens, Class 347 B.C., Professor of Philosophy, Ethics, Drama, Biology, Politics, and Economics at the Lyceum of Athens, Consultant to the Royal Macedonian Treasury, Chairman of the Council of Advisors to King Alexander) lists amongst others the following examples of successful revenue-raising techniques:*

Hyppias of Athens had the idea of offering for sale all parts of houses projecting into public streets such as steps, fences, balconies, upper rooms, and doors opening outward. At once the frightened home owners contributed a sizeable sum by buying back the offending parts of their own property. Today, a device of this sort would yield considerable revenues in such balcony-loving cities as San Juan or New Orleans.

When the relatively conservative Byzantines needed money, they sold, in return for a third of the profits, the trading rights of fish mongers, salt sellers, jugglers, soothsayers, druggists, etc. For a stiff fee, they permitted children of marriages between citizens and aliens to acquire the political rights usually reserved for pure Byzantines. And as a last resort, they even sold sacred enclosures hoping, presumably, that their gods might be looking the other way.

An ingenious and, this time, painless method of raising funds was devised by Heraclea in its effort to send 40 ships against the tyrants on the Bosporus. Against the promise of future payment, the city brought up all the necessary corn, oil, wine, and other provisions, putting everything on merchant ships which were to accompany war vessels. At the same time, it paid the soldiers two months' pay in advance. "When they reached the enemies' territory, the soldiers bought up all the provisions from them. Thus money was collected before the generals had to pay the soldiers again, and so the same money was distributed time after time until they returned home."

Mausolus, the tyrant of Caria, collected revenues for the king of Persia with a technique still used in fund-raising campaigns. Assembling the richest men, he ordered some of his subordinates to announce publicly their pretended don-

* From Aristotle's *Oeconomica*, translated by E. S. Foster in the *Works of Aristotle*, edited by W. D. Ross, Oxford University Press. Quotation on the last page taken from Herodotus.

ations. Through shame and fear the wealthier men then contributed much larger sums. Candalus, a governer under Mausolus, developed an equally effective trick. Noticing the fondness of his subjects for wearing their hair long, he pretended the king of Persia required large quantities of hair for making false fringes. They must therefore cut off their hair. However, if they would pay a poll tax, Condalus let it be known that he would send to Greece for hair. "They gladly gave him what he asked."

One of the most inventive Collectors of Internal Revenue must have been Dionysius of Syracuse. At one time he told of the goddess Demeter's appearing to him in a dream, demanding that all women deposit their ornaments in her temple. After a while he appropriated them, declaring that Demeter had lent them to him. When women began wearing ornaments again, he ordered them to deposit a luxury tax for each piece in the temple. At another time, he demanded a contribution from every citizen for the purpose of annexing a city which was to be betrayed to him. A few days later, commending the people on their generosity, he returned to each his contribution since, as he said, he had failed in his attempt. Having thus won their confidence, they gladly contributed when he approached them again. But this time he kept the money. Asking for funds once more after this, the citizens declared "they had nothing to give. Accordingly he brought out his own household goods and offered them for sale, as though compelled to do so by poverty. When the Syracusans bought them, he kept a record of what each had bought, and when they had paid the price, he ordered each of them to bring back the articles which he had bought."

Aristotle's (or his students') report on governmental fund raising published in Book II of his *Oeconomica,* contains many more items indicative that the state's uncanny ability to extract every last cent from its sorely tried citizens was not less highly developed in antiquity than it is today. The most fascinating item, however, is recorded not in Aristotle but in Herodotus (II, 126), who writes about a rather unique excise tax designed by King Cheops of Egypt in his effort to finish his famous pyramid, in the following terms:

"And so evil a man was Cheops that for lack of money he made his own daughter to sit in a chamber and exact payment (how much, I do not know; for they did not tell me this). She, they say, doing her father's bidding, was minded to leave some memorial of her own, and demanded of everyone who sought her favors that he should give one stone to set in her work; and of these stones was built the pyramid that stands midmost of the three, over against the great pyramid; each side of it measures one hundred and fifty feet."

Poor taxpayers, having to lug a heavy stone along with the gold to the collector's chambers! But what a monument to the government's inexhaustible store of techniques for getting hold of the money of its citizens. And what a monument to the citizen's ultimate readiness to abandon his resistance, building pyramids not only for the glory of the state, but also of the collector. ☆

New decisions affecting individuals

Wife liable on joint return which she neither authorized nor signed. After taxpayer furnished her husband's accountant with information about her 1951 income, the accountant included it on a joint return without her knowledge or consent and signed her name to the return. Three months later she endorsed the refund check, and in a separate return for 1952, she stated that she filed a joint return for 1951. The Tax Court concluded that taxpayer acquiesced in and gave her tacit consent to the filing of a joint return for 1951 and was therefore jointly and severally liable for that year's deficiencies. In the Tax Court the trial judge dissented on the ground that she testified she did not authorize filing of the joint return; he questions the veracity of the accountant. Three other judges concurred in this dissent on the ground a conflict of testimony should be left to the trier of the facts. This court affirms the Tax Court majority on the ground that the record furnishes substantial support for its opinion. While great weight should be given the views of the judge who heard the evidence, the Tax Court is not bound thereby. *Heim,* CA-8, 1/17/58.

Sheepraiser's loss held separate, not community. At issue here is the amount of taxpayer's carryback from 1951 to 1950 on a loss from death of sheep. Taxpayer had married his second wife in 1951 and if the loss occurred prior to the marriage, it was a loss of his separate property and he could carry it back to 1950. If the loss occurred after his marriage and was a loss of sheep acquired after the second marriage, it was a community loss and only one half could be carried back. The district court had held merely that taxpayer had not borne the burden of proving the loss was separate. This court reverses, finding the evidence clear that the loss was separate. *Wasson,* CA-5, 1/7/58.

Policeman's subsistence exclusion allowable without proof of expenses. Taxpayer was a policeman of the city of Albany, Georgia, which, in October 1955, reduced the salaries of all policemen $5 a day and gave them a $5-a-day subsistence allowance. The court holds the allowance excludable under Section 120 of the 1954 Code, which excludes from gross income a policeman's "statutory subsistence allowance" up to $5 a day. The Commissioner had argued that taxpayer had to show that he incurred expense of that amount while away from home. In the court's opinion, however, subsistence in its ordinary usage does not mean away-from-home expenses. *Parrish,* DC Ga., 1/9/58.

Trustee can't deduct defense costs in mismanagement suit. Taxpayer was trustee and life beneficiary of her husband's estate. She incurred legal fees in connection with a lawsuit by the remaindermen charging her, as trustee, with waste and mismanagement of trust assets. The court holds that taxpayer cannot deduct these fees as a business expense because she is not a professional trustee. Moreover, since taxpayer received no compensation as a trustee, the fees are not deductible as a nonbusiness expense "for the management, conservation, or maintenance of property held for the production of income." *Barnhart,* TCM 1958-11.

Tenant in common can deduct full tax and interest. Taxpayer and his daughter inherited property as tenants in common and taxpayer conveyed his interest to his daughter to take it out of his creditors' reach. The court finds that he retained his beneficial interest, there

being no intent that anything but bare legal title be passed by the conveyance. Accordingly, in paying all the interest and taxes on the property, taxpayer was satisfying his own obligation as a tenant in common, and not that of his daughter; he may deduct it all. *Conroy,* TCM 1958-6.

Unexplained cracks in building not a casualty. Taxpayer discovered that his nearly completed river-bank house had cracks in the ceilings and walls which the architect and contractor believed were caused by "something unusual." The court denies taxpayer a casualty loss deduction for $21,700 on the ground that he failed to prove that the cracks in the house were caused by a shifting or movement of the earth under the house, or by a subsoil shrinkage or condition, and that they were not caused by the gradual settling or subsidence of the house, or by faulty materials, faulty work, or the drying of materials. Furthermore, the court notes that taxpayer failed to produce proof of value of property before and after the alleged casualty to substantiate a loss in any amount. *Tank,* 29 TC No. 77.

Lump sum payments in lieu of alimony nondeductible. Pursuant to a divorce decree in 1944, taxpayer agreed to pay his wife monthly alimony and to pay premiums on an insurance policy on his life as long as she lived or remained unmarried. In 1951, under an amendatory agreement, he was relieved of any further obligation to pay alimony and support upon his promise to make two payments of $6,200 and $2,000 and to transfer to his former wife all interest in the policy of insurance on his life. The two payments plus the cash surrender value of the policy are held not deductible as periodic alimony payments; they were installment obligations of an absolute nature not dependent upon any contingencies. *Ashcraft, Jr.,* CA-7, 2/20/58.

Fee for negotiating property settlement in divorce is deductible. Taxpayer agreed to a divorce, but refused to make the property settlement demanded by his wife, which would have forced taxpayer to sell his stock in the corporation that employed him. The stock ownership (11%) paid him some $18,000 annually in dividends; his salary was about $17,000. Negotiations on the property settlement were long and ended only when taxpayer developed evidence of her misconduct and threatened exposure. Agreement and divorce followed quickly. Taxpayer paid his attorney two separate fees—$2,500 for the divorce proceeding itself, and $8,000 for negotiating the financial settlement. The court allows deduction of the $8,000. It was incurred to protect income-producing property. *Fisher, DC* Penna., 12/27/57.

Expenses of defending divorce property settlement agreement deductible. Several years after taxpayer, a CPA, had been divorced, his former wife attacked the divorce property settlement agreement on the ground of fraud. She sought to have the decree modified so as to have some income-producing property transferred to her. The court holds that the expenses of defending the suit are deductible as a nonbusiness expense. The suit, if successful, would have injured taxpayer's earning ability by hurting his reputation. Furthermore the expense was necessary to conserve income-producing property. *Glick,* DC Ill., 1/30/58.

Accountant didn't know income was separate; returns, in form separate, held joint. Taxpayers had for years relied on their accountant to prepare returns at the lowest tax; they therefore filed the separate returns he made up for them. However, the accountant did not know that the chief item of income, certain royalties, was not community income (reportable one half on each separate return), but was the husband's separate income (reportable in full on his separate return). The deficiency involved here is some $3,000. The court finds that the accountant's mistake of the taxpayers' antecedent legal rights was a mistake of fact and that the taxpayers' election of the separate return, based on reliance on the accountant, was not an intentional decision which would bind them. *Kiesling,* DC Tex., 1/3/58.

Jury finds payment under divorce decree was not alimony. An agreement which was incorporated into the subsequent divorce decree provided for certain payments to be made by the taxpayer-husband. The jury is asked to decide from the evidence whether these payments were made pursuant to the marital obligation, and thus deductible alimony, or for some other purpose. [The nature of the controversy is not revealed; it is suggested the payments may have been repayments of loans.—*Ed.*] The jury finds the payments were not alimony. *Thorsness,* DC Ill., 2/12/58.

Tax consequence of alimony decree not altered by subsequent reduction in payments. An alimony decree which provided for the support and maintenance of a wife and minor child made no allocation between the wife and child. The IRS rules that the wife must include the full payment in gross income. A subsequent reduction by the court on the ground that the child had attained majority will not retroactively alter the tax consequences of the original decree. *Rev. Rul.* 58-52.

Husband can't deduct alimony award earmarked to pay joint indebtedness. A portion of an alimony award was allocated to the payment of installments due on a note which was a first lien against jointly owned property and upon which both husband and wife were liable. The IRS rules that payment of this part of the alimony award is the discharge of an obligation, not periodic alimony, and is not deductible by the husband nor includible in the wife's income. *Rev. Rul.* 58-52.

Farms owned at different locations separate businesses for hobby loss disallowance. Under 1939 Code section 130 (Section 270 of 1954 Code), an individual who sustains a loss from a business (excluding taxes and interest) of more than $50,000 for five consecutive years is limited to a maximum loss allowance of $50,000 for each of the years. Taxpayer conducted farming operations at four geographically separated locations in Texas, Mexico, Florida, and the Bahamas. The Commissioner contended that two of the operations constituted one business with an over-all maximum loss over a five-year period of $50,000. The court, however, disagrees and, noting this is the first time this question has arisen, finds that the separateness of operations necessitated by the distance between the farms and the fact that each was in a different country with different conditions relating to finances established them as two separate, independent business units. *Davis,* 29 TC No. 95.

Teacher can deduct tuition to get required degree. Taxpayer was a tutor at one of the New York City colleges. To retain his position, he was required to be working for his doctorate. The Tax

Court denied him a deduction for the expenses incurred in these studies. [See article on Tax Court opinion in 6JTAX 169.—*Ed.*] Three Tax Court judges dissented. They based their dissent on *Hill* (181 F2d. 906) which held education necessary to retain a job is deductible even if it also helps the taxpayer advance in his profession. This court reverses, saying it agrees with the dissenting opinion. *Marlor,* CA-2, 1/31/58.

Nebraska gasoline and cigarette taxes deductible by consumer. The Nebraska motor vehicle fuel tax paid by dealers and passed on to consumers is not a tax imposed on the consumer and is not deductible by the latter under section 164(a). A consumer paying such tax other than in connection with his trade or business may, however, deduct the tax under section 164(c). IT 3669 revoked. *Rev. Rul.* 58-44. The Nebraska cigarette tax on cigarettes distributed and sold at wholesale and on their use in the state is considered a tax imposed upon the consumer and is deductible by the consumer under section 164(a). *Rev. Rul.* 58-45.

Double penalties for failure to file declaration (Old Law). Taxpayer failed to file an estimated tax declaration for 1953 and this court imposes both the penalty for failure to file and the penalty for substantial underestimation. This holding is in accord with the view of the Tax Court and certain other district courts; some district courts take the contrary position that the underestimation penalty does not apply where there is no estimate. [The 1954 Code provides for a single addition to the tax for substantial underestimates.—*Ed.*] *Palmisano,* DC La., 1/22/58.

No alimony deduction for support of stepson. A divorced husband is not entitled to deduct periodic payments specifically allocable to the care and support of his wife's minor son, even though the relationship is that of stepfather-stepson. No part of the payments allocated to the support of the child was to belong to the wife or to be used for her benefit. *Faber,* 29 TC No. 115.

Common-law wife recognized as taxpayer's spouse. A common-law marriage, if entered into in a state which recognizes such marriages, is also recognized for Federal income tax purposes. *Rev. Rul.* 58-66.

Daughter in sanitarium qualifies parent as head of household. Taxpayer's daughter had worked for many years in New York and Washington, but had spent her vacations at taxpayer's home in Sioux Falls, S. Dak. The daughter is now in a sanitarium. Taxpayer keeps most of her daughter's personal possessions in her home, maintaining a room for her. The daughter intends to return to Sioux Falls when she recovers from her illness. The court holds taxpayer's home is her daughter's "principal place of abode" although she did not live there immediately before entering the sanitarium. Accordingly, taxpayer has the status of head of a household. *Reardon,* DC S. Dak., 2/17/58.

Church contributions are dependent's support; income taxes not. In computing the total amounts expended for the support of a dependent, income and Social Security taxes paid by the dependent from his own income are not support. However, the term "support" does include church contributions. *Rev. Rul.* 58-67.

Advice of CPA-attorney good reason for not filing tax estimate. Taxpayers did not file a declaration of estimated tax on the advice of their CPA-attorney that an estimate was not necessary because most of their income was subject to withholding. The court holds that this constitutes reasonable cause for the failure to file and, therefore, no penalty is due. *Burck,* DC Ind., 1/28/58.

Constitutionality of estimated tax provisions upheld. Taxpayer attacks the constitutionality of the estimated tax provisions because they require tax payments based on a "guess" at a time when possibly there has been no income. The court finds no merit to these objections. The system of estimating taxes is an appropriate system for collecting taxes authorized by the Sixteenth Amendment. *Erwin,* CA-9, 2/13/58.

Strike benefits are income. Taxpayer took part in the Kohler strike and received strike benefits from the UAW. He was not required to serve on the picket line to be eligible for strike benefits. The court sets aside a jury decision for the taxpayer and holds that the strike benefits were taxable income, not a gift. That the constitution provided for the strike benefits, and that taxpayer had to continue on strike to be eligible for them, show that this was the payment of an obligation, rather than a gift. Furthermore, the IRS has for 38 years consistently held strike benefits are taxable; in view of the inaction of Congress on a matter that affects so many persons, this must be regarded as approval by Congress. *Kaiser,* DC Wis., 2/19/58.

Reasonable cause doesn't avoid underestimation penalty. Although reasonable cause is a defense for failure to file an estimate under the 1939 Code, it is no defense to the penalty for substantial underestimation. [Under the 1954 Code there is a penalty computed on the amount of the underpayment only and there is no provision for remission for reasonable cause.—*Ed.*] *McMurtry,* 29 TC No. 114.

Two-year job not temporary. A boilermaker who resided in Alabama was sent by his union to Rome, Georgia, for employment there in installing three large steam boilers. With the exception of two brief periods of about two weeks each, when a non-related union was on strike, he was continuously employed at the Rome plant for a period of approximately two years. The court denies him claimed meals and lodging in Rome, Georgia, as traveling expenses while away from home, holding his employment there was not "temporary." It was, it says, of "indefinite" duration. Five judges dissent. The mere length of time that the job actually lasted does not show that this was more than a temporary job. A deduction should be allowed so long as the job is not permanent or of indefinite duration. This taxpayer was subject to assignment by his union. It would be unreasonable to expect him to move. *Claunch,* 29 TC No. 109.

Winner of Irish Sweepstakes allowed to split prize with family. Taxpayer purchased a one-half ticket in the Irish Sweepstakes, using as a pseudonym "Clancyites." The ticket won first prize. On the facts the court finds that taxpayer purchased the ticket with the intention at the time of including her husband and two childen with herself as owners and the Commissioner, therefore, erred in taxing the children's share of the winnings to her. Taxpayer's failure to take proper legal steps to effectuate the gift until after the ticket was selected as winner is considered as due to "artlessness" and is not deemed to be material. *Chelius,* TCM 1958-29.

CORPORATE & PERSONAL PROBLEMS IN

Taxation of compensation

EDITED BY JOHN P. ALLISON, LL.B.

Executive compensation: a check list of items in the tax-sheltered package

by **RICHARD L. GREENE and FRANK W. HAMMETT**

Executive compensation being so important to good business management, the tax man finds himself frequently called on to find ways to increase net pay to an executive. In considering the topic, he may find himself immersed in the minutiae of planning; yet, if his counsel is to be truly valuable, whether he is aiding the corporation or the executive, and most particularly if the two are in effect one in a closely held company, it is necessary for him to retain his perspective. Mr. Greene here comments briefly on the principal compensation devices popular today to reduce taxes. He points out principal advantages, hazards of each under current cases.

THE MODERN TREND in compensating corporate executives is the multiple form of compensation. This executive pay package has grown out of the corporate need of finding and retaining high quality management and the executive's need for building up a fund for his retirement and for the protection of his family — all at a minimum tax cost. The typical pay package will consist of these components:

1. The basic salary at a fixed annual rate.
2. An incentive feature, usually in the form of a bonus.
3. Deferred or retirement elements, either a pension or profit-sharing plan or a deferred-compensation contract, or frequently both.
4. Family protection elements, such as death benefits under the pension or profit-sharing plan or deferred-compensation contract, plus possibly group insurance.
5. Ownership element — such as stock options or stock-bonus or purchase plans.
6. Various fringe benefits.

The test of reasonableness

We are reminded occasionally, when the revenue agent beats on the door of our closely held corporate client, that the compensation of executives must be reasonable in amount to be deductible. The curse of this broad statutory test is that it gives the revenue agent a great deal of power to determine what *he* considers to be reasonable. If he disallows a part of the compensation and his determination stands, the corporation loses part of its deduction, but the executive is still stuck with the tax on the total amount received.

In this connection, we are liable to overlook the fact that the test of reasonableness is not applied to merely the base salary and bonus. It also includes the other forms of compensation received. That is particularly true as to the executive's share of the contribution to the profit sharing plan.

Types of bonus: cash or stock

The function of the bonus is, of course, to furnish an incentive to the executive and to gear his compensation to his performance. In most cases the bonus is paid in cash, but there is a growing trend to make the payment in the stock of the employer. Either type will serve to accomplish the basic function. Which is more desirable will usually depend on the needs and plans of both the executive and the company.

Suppose the mythical but typical Baker Corporation is short of cash this year, but has a very valued vice-president Brown, who has been receiving tempting offers from competitors of Baker Corporation. Baker already has a pension plan and it can't afford to increase Brown's salary this year. Also Brown would like to have a direct stake in the company. Hence, Baker pays him the regular salary of $15,000, plus a bonus of 100 shares of stock worth $5,000.

Baker Corporation receives the deduction on the $5,000 worth of stock paid as a bonus and at the same time retains the needed cash equivalent. Brown is happy because he is now a stockholder in the business and didn't have to pay for it. He is bothered by only one thing. He has to pay $1,500 of income tax on the $5,000 value of the stock and this would have to come out of his regular salary. The usual solution to this problem is that Baker Corporation would pay not only the stock bonus but also enough additional cash to cover the income tax on the bonus.

Thus, stock bonuses serve the double purpose of providing the corporate deduction while preserving the cash, and likewise giving the executive a direct stake as a stockholder in the business. Frequently stock bonuses are paid under a continuous plan, which provides considerable advantage over a period of time.

Where the stock has no market, there may be a valuation problem and this should be handled by a buy-and-sell agreement or restrictive by-law which establishes a reasonable and fair price formula under which the company and other shareholders will purchase the stock under cetain conditions, such as death or retirement.

Contingent compensation plans

In this modern era of keen competition for high-grade executive talent it is becoming quite common to provide for bonuses under a definite and formal plan. This furnishes more certainty and security to the key executive, whose additional compensation is then no longer at the whim of the employer.

The bonus plan is either set up by appropriate resolution in the minutes or included in a formal employment contract with the executive. Either way it should be approved by the board of directors, and in some cases, depending on the state law, should probably be ratified by the shareholders. In order to be workable over a period of time and to

truly function as an incentive to the executive, the bonus is set up as contingent compensation. This usually means the amount of the bonus is contingent upon some variable that measures the contribution of the executive and the prosperity of the company.

The typical contingent compensation formula is expressed as a percentage of sales or as a percentage of profits. Returning to Brown, the vice president of Baker Corporation, let's assume that Brown is vice president in charge of sales. A contingent compensation plan is set up designed as an incentive to him and to promote sales. Brown receives a base salary of $20,000 per year and 3% of all sales over the average of $400,000 per year. If the sales shoot up to $1 million, Brown's bonus will be 3% of $600,000 or $18,000.

Suppose Baker sales do climb up to $1 million, but because of increased costs of material, net profits before the bonus to Brown increase only slightly and the stockholders could be rightfully aggrieved if Brown's bonus interferes with their dividend. In that situation a ceiling would have been placed on Brown's bonus tied to the amount of net profits.

In the case of a small closely held company, particularly where dividends are kept low to permit company growth, a contingent compensation plan formula tied to profits is more vulnerable to question by Internal Revenue. Revenue agents occasionally claim that to the extent the total compensation paid is excessive in amount, the bonus or part of it, is akin to a dividend.

Generally, contingent compensation plans formalized by a contract or authorized by resolution are recognized and followed by the taxing authorities and by the courts. The longer the plan has been in effect the greater sanctity it takes on taxwise. One of the greatest areas of tax litigation is whether a long-established contingent compensation formula is binding if it produced a reasonable amount originally but many years later the formula produced greatly higher amounts. Most of the tax decisions accept the formula if it was set up under an arm's length arrangement and originally produced a reasonable amount of compensation, even though the amount increased greatly over the years. The major point here is that the parties should adhere to the terms of the contract year after year, if they wish it to stand up for tax purposes.

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Deferred compensation contracts

Of course, the basic function of a deferred compensation agreement is to defer the income to the executive to a time when he is retired and in a lower tax bracket. The problem is to prevent the Treasury from challenging the deferred pay deal on the ground the money is taxable to him under the theory of constructive receipt. This challenge could conceivably be made at one of two points of time — either in each year the deferred amount is credited annually to the employee on the corporate books, or at the time the entire fund has accumulated. The first possibility would be bad, the last would be disastrous.

Such deferment, however, is possible and the Milton Berle contract is a classical example. In 1951, Berle had been receiving $13,500 for each performance or $1,500,000 in three years. At his bracket the Government took 75% of the income and Berle received only 25%. A new contract was worked out so that Berle receives $50,000 a year for 30 years. In that way he keeps 60% instead of 25% of the income.

The way Berle's contract operated was as follows: For the first five years Berle works 39 weeks. For the next five years he must perform 25 weeks. For the next ten years he need not perform, but is available as a producer, writer, director or consultant. For the last ten years he has no obligation to do any work.

An examination of proxy statements of listed companies demonstrates that many of the large corporations are using deferred compensation contracts. These include Corn Products Co., General Electric, Stewart-Warner, Safeway Stores and countless others.

The basic contingencies

While they vary somewhat in form and terms of deferment, the basic feature of all is that the payment of the deferred sums is contingent on at least these two conditions: (a) the executive after retirement will not engage in a competing business; (b) the executive will be available and will perform any consulting and advisory services required by the company.

Since the executive is required to perform these contingencies usually during his lifetime in order to receive the payments, the principle relied upon is that there can be no constructive receipt. Hence the payments should be taxable to him only in the year of payment. In other words, since the deferred bonus may be forfeited it cannot be considered as constructively owned by the executive in the year it is earned.

In order to accomplish this deferment of tax and to protect the deferred contract from Treasury attack, these contingencies must be realistic. So, also, the more real conditions the better. In addition to the usual consulting service and covenant not to compete provisions, it may also be appropriate to make the amount of future payments contingent upon the amount of company profits, or the cost of living, etc.

Tax summary

1. The employer gets the deduction not in the year of the credit, but in the year the deferred amount is paid out to the employee. That is, the year of deduction and year of taxation are normally the same.

2. As indicated before, if the contract contains contingencies, the income tax should be normally deferred until the year of receipt. The Treasury has been reluctant to concede this point, but I understand a mimeograph has been drafted, which clears this point if the contingencies are real. The payments are, of course, ordinary income. This should be contrasted to the capital gain treatment afforded lump-sum payments upon retirement under a qualified profit-sharing plan.

3. It is not entirely clear whether the death benefits are subject to death taxes in view of the contingencies. This may depend on the type of arrangements or the state of the decisions at the time the question arises. If the contract provides for death benefits or continuation of payments to the widow, which amounts to an annuity, the value of the payments is probably subject to death taxes under Section 691 of the Code. We note the recent *Goodman* (243 F.2d 264) case held the commuted value of the deferred payments subject to estate tax under the 1939 Code, rejecting a contention based on the contingencies.

We will consider later the desirability of a profit-sharing plan for key executives.

The tax advantages of such a plan are even greater than the deferred compensation method, particularly with respect to the tax treatment of payments on retirement or death. In many cases, a profit-sharing plan will not of itself provide a sufficient fund for comfortable retirement and adequate security to the family. This situation arises often from the extent of the coverage of several or numerous employees. So, also, the deferred compensation contract may not by itself provide entirely adequate retirement and death benefits. Thus, the modern tendency is to arrange for both a qualified plan and a deferred compensation contract, which together will provide adequate amounts. More and more corporations today have arranged for this double package to attract and retain their key executives.

A deferred compensation contract

We noted at the outset that the modern technique is the executive pay package or multiple compensation. Here is a practical illustration of the workings of a contract we recently set up to secure the services of a key executive for a successful closely held company:

1. *Base salary* for ten years of $30,000 per year.
2. *Bonus or contingent compensation* based on 2% of sales, with a ceiling of total salary and bonus of $50,000.
3. *Retirement benefits or deferred compensation* of $15,000 per year commencing at age 60 for 15 years.
4. *Disability benefits* of $15,000 per year for permanent disability.
5. *Death benefits* of $18,000 per year for 15 years to the widow or testamentary trustees.

Thus, the total pay package provided for amounts upward of $500,000 of compensation during the ten-year period of active employment, plus total retirement benefits for 15 years upwards of $225,000, plus disability and death benefits. The retirement benefits are, of course, contingent upon completing the ten years of active service plus the standard competitive and consulting provisions to operate during the 15-year retirement period. While the amounts were quite sizable, the arrangement was fairly standard and demonstrates the trend towards complete compensation, retirement and death benefit coverage in a single executive pay package.

In the foregoing illustration, we provided for a corporate life insurance policy in the face amount of about $200,000 to aid the corporation, if necessary, in the financing of the retirement, disability and death benefits. We did not tempt fate and the tax collector as did Mr. Casale (247 F.2d 440) who had to litigate to the court of appeals to avoid being taxed upon the premiums paid on the policy issued to cover contingent compensation. In our illustrative case, the life insurance on the key executive was not issued at the time of execution of the deferred-compensation arrangement. They were wholly unconnected events and no reference was made to insurance in the deferred contract. The company applied for the insurance policy and was the sole owner and sole beneficiary and, of course, the cash surrender value was available, if necessary, for general corporate purposes or to pay off creditors, etc.

Without doubt a qualified profit-sharing or pension plan offers a unique package of tax benefits for both employees and employer.

First, as to the employer, the company secures the full benefit of the tax deduction for the amount contributed to the plan.

Second, neither the employer, the employees, or anyone else is taxed on the dividends, interest or other investment income while it is being earned in the profit-sharing or pension trust.

Third, when the employee takes his share of the fund out upon retirement, he can receive it at capital gain rates. This rule applies even to the interest and dividends that have accumulated in the fund for his benefit.

Fourth, the entire amount received by his beneficiaries upon his death is now free of Federal estate taxes.

Fifth, his beneficiaries not only receive capital gain rates for income tax purposes, but may also be entitled to an exclusion of $5,000. This means that usually they receive a tax-free death benefit of up to $5,000.

All of this adds up to a wonderful way for the executive to build up a sizeable fund for his retirement and for his family after his death. The charm and magnitude is best realized by a simple illustration. Suppose vice president Brown receives a salary of $30,000 per year, plus a cash bonus of $5,000. At his tax bracket, he keeps $2,000 of the $5,000 after state and Federal income taxes. In 15 years, if he is firm enough to save and not spend the $2,000 annually, he will have $30,000. If he dies the entire $30,000 is subjected to death taxes and if his estate was in an assumed 30% bracket, that would leave only $21,000 for his family.

Now if that same $5,000, instead of being paid out as a bonus, were put into a qualified profit-sharing plan, it would be tax-free annually and build up to $75,000 in 15 years. Without taking into account the tax-free earnings built up on the $75,000, Brown would receive $75,000 on his retirement instead of $30,000, at which point he would pay capital gain tax of 25% and end up with about $56,000 after taxes. Thus, by having the same money go into a qualified plan he builds up a fund almost twice as great for his retirement.

So also, in the event of his death, the $75,000 would go to his family free of estate taxes, instead of $21,000 after estate taxes.

Continuation after retirement

A recent ruling (*Rev. Rul.* 57-115, IRB 1957-12) points up the danger of allowing the retiring executive to continue to render any service to the employer as an officer or a director when the executive has received a lump-sum distribution from the employer's profit-sharing plan where he desires capital gain treatment on the distribution. Under this ruling it matters not how insignificant his services may be or that he is not compensated for the continued service. When drawing deferred compensation contracts for executives who are also participants in the company's qualified profit-sharing or pension plan, the contract should make it clear that the executive will not be an employee, officer or director of the corporation after retirement. In this respect, particular attention should be given to the contract language relating to the advisory services of the retired executive which the company can request.

Not to be forgotten in rounding out the executive compensation pattern are the death benefits that may be paid to his widow or other beneficiaries. Drawn properly, an executive's widow, for example, can receive $5,000 tax-free under a death benefit contract after the executive's death. Decisions have been trickling down from the courts in increasing numbers holding that voluntary payments by the employer to the widow of the deceased executive may also be deemed tax-free gifts to the widow. In

at least one recent case, however, the court found that voluntary payments to the widow and sisters of the deceased employee who were major stockholders in their own right were dividends to them.

The current crucial qustion in the area of death benefits is whether, under Section 101(b) of the 1954 Code, all voluntary payments to the beneficiary in excess of $5,000 will be deemed taxable income to the beneficiary. While many tax men feel that Section 101(b) imposes no such limitation, there are some dicta to the contrary in the recent *Rodner* (149 F Supp. 233) case. It is expected that before long a decision will give the answer. But regardless of the outcome of that problem, the value of the death benefit in the executive's compensation package should not be overlooked.

Another popular form of compensating the modern executive is the stock option. Because the usage is quite limited in the case of small companies or those whose stocks have no market, and because the rules on restricted options are quite involved, we will pass over them with only a few comments.

While restricted stock options perform a valuable function in many situations from the standpoint of attracting executive talent, frequently they are not desirable for any one of these reasons:

1. First, if the stock is not listed and has no market, it is difficult to satisfy the 85% or 95% statutory test to make it a qualified stock option. There are ways around this difficulty, but I think none has received a real test as yet.

2. Second, as contrasted to the stock-bonus plan which gives an immediate deduction to the corporation, the company gets no deduction for granting a restricted stock option.

3. Third, frequently the exercise of the option will seriously dilute the equity of the other shareholders.

4. Fourth, the executive has to invest a large cash amount and may never be able to finance the exercise of the option.

Note also that there are non-restricted stock options. These were known as "proprietary stock options" and were quite highly regarded until the Supreme Court recently held in the *Lo Bue* case that generally executives realize taxable ordinary income at the time the option is exercised. While there still may be some area of usefulness of the non-restricted type of option, the law seems to be a bit fuzzy and hence their popularity has waned. ☆

SEC survey shows large growth of corporate pension funds; assets increase 12% in year

Assets of pension funds of U. S. corporations aggregated $16.6 billion (book value) at the end of 1956, an increase of $2.4 billion during the year, according to the third annual survey of the Securities and Exchange Commission. The summary excludes corporate pension funds administered by insurance companies. Reserves in these funds increased $1.2 billion during 1956, amounting to $12.3 billion at the end of 1956, according to the Institute of Life Insurance. The growth in 1956 compares with increases of $2.1 billion in 1955 and $1.9 billion in 1954.

The survey indicated that at the end of 1956, 78% of corporate pension fund assets were invested in corporate bonds and stocks, as compared with 75% so invested a year earlier. Over 52% of assets were invested in corporate bonds, over 26% in common and preferred stock, 14% in U. S. Government securities, and 8% in other assets.

A comparison of the book value and market value of pension fund assets at the end of 1956 is given below. This table shows that while common stock investments at book cost comprised only 23% of total assets, they made up almost one-third of the market value of total investments. On the other hand, corporate and U. S. Government bonds accounted for two-thirds of the assets based on book value, but only 57% based on market value. As of December 31, 1956, the market value of common stock investments exceeded book value by 50%; corporate bonds had a market value of 91% of book value, and U. S. Government bonds were valued at 96% of book.

Total receipts of pension funds amounted to over $2.9 billion in 1956, $400 million higher than in 1955, and almost double receipts in 1951. Employers' contributions made up 70% of the 1956 and 1955 receipts, contrasted with 80% in 1951. The growing importance of income from interest and dividends on investments as a source of funds is illustrated in the figures in the table below; in 1956 interest and dividend income amounted to $560 million and supplied 19% of total receipts, whereas in 1951 such income amounted to less than $200 million and supplied only 12% of total receipts. Because data on profits and losses and other income were not requested prior to 1955, total receipts are not strictly comparable with the 1955 and 1956 figures. Employee contributions of $270 million in 1956 accounted for 9% of total receipts, slightly higher than in 1955. These contributions have increased moderately each year but in relation to total receipts have remained quite consistent. In addition to these income items, a net profit of $50 million from the sale of assets and $20 million of other income was reported.

Disbursements from corporate pension funds included $545 million of benefit payments to pensioners and $13 million of expenses chargeable to the funds. Benefit payments were $100 million greater than in 1955, representing an increase of 22%. ☆

PENSION FUND ASSETS, END OF 1956

	Book Value		*Market Value*	
	$ Million	*% of Total*	*$ Million*	*% of Total*
Cash and deposits	332	2.0	332	1.9
U. S. Government Securities	2,293	13.8	2,192	12.5
Corporate bonds	8,704	52.3	7,904	45.0
Own company	776	4.7	682	3.9
Other companies	7,928	47.6	7,222	41.1
Preferred stock	570	3.4	524	3.0
Common stock	3,774	22.7	5,648	32.2
Own company	505	3.0	864	4.9
Other companies	3,269	19.6	4,784	27.2
Mortgages	230	1.4	229	1.3
Other assets	736	4.4	735	4.2
Total assets	16,639	100.0	17,565	100.0

New compensation decisions this month

Retirement pay taxable despite "unfitness" for duty. When taxpayer was retired from the Navy, he was found not physically qualified for duty. However, his retirement pension was based on service time and he was rated as not disabled. The court holds that, since no part of taxpayer's retirement pay was based on disability, he does not come within the provisions exempting armed forces disability pay from tax. *Freeman,* DC Calif., 2/13/58.

Employee plan was savings, not profit-sharing; no deduction for forfeitable contributions. Taxpayer set up an employee trust which in effect matched savings contributed by the employees. The court finds that scheme was not one of the statutory plans for which deduction is allowed; it was not a pension, annuity or stock bonus plan; it was not profit-sharing because matching would be required in the event of loss; and, since the employer's contributions were forfeitable under several contingencies, it cannot come under the general rule allowing deduction for nonforfeitable contributions. The court indicates that the company deliberately set up the plan without regard to tax consequences—it had sought advance rulings on its pension plan, but did not here, and officials told IRS men that the plan was achieving the good will it was designed to create and would be continued whether or not contributions were deductible. *Mississippi River Fuel Corp.,* DC Mo., 2/5/58.

Retirement pay of non-disabled military personnel not sick pay. Military personnel who are under the mandatory retirement age of 62, and who are on the retired list for reasons other than physical disability, are not considered absent from work on account of personal injuries or sickness. They cannot therefore exclude any part of their retirement pay as "sick pay." *Rev. Rul.* 58-43.

New excess profits tax decisions

EPT relief granted based on net abnormal income attributable to prior years. The court holds a portion of the income of a manufacturer of coated fabrics from sales of a developed resin product during 1942-1945 constituted net abnormal income of a class specified by Section 721(a)(2)(c) due to exploration, discovery, research or development attributable by that section. *General Tire & Rubber Co.,* 29 TC No. 103.

Construction corporation similar to predecessor; can't use "new" EPT rates. The EPT tax was assessed at special low rates for the first five years of a corporation's existence. However, the law required the new corporation to treat as years of its own existence the years of a similar corporation owned by the same interests. The court finds that another corporation was so similar to taxpayer as to be identical with it. Therefore taxpayer must add on the other's two years of existence. *Gersten,* 28 TC No. 84.

Cancellation of subsidiary's debt was capital paid in for Korean EPT. To finance capital improvements, taxpayer advanced $53,000,000 on open account to its wholly owned subsidiary. This debt was subsequently cancelled and entered on the books as a capital contribution. Shortly thereafter the subsidiary was merged into the taxpayer. The Commissioner contended that the cancellation served no business purpose but was made solely to avoid recognition of gain in taking over the assets of the subsidiary. In view of the obvious undercapitalization of the subsidiary, however, the court concludes this was a contribution to capital in good faith for the purposes of the business. Accordingly, credit is allowed in computing the daily capital addition, increasing the excess profits credit. *Anderson, Clayton & Co.,* Ct. Cls., 12/4/57.

Corporation not formed to avoid excess profits tax can use "new corporation" rates. Taxpayer corporation was organized in 1953. It purchased the assets of a going business from another corporation with the same stockholders but having different proportionate ownership. Since the old corporation had sufficient excess profits tax carryovers to absorb the combined income of the two corporations, avoidance of excess profits tax was not, the court finds, the motive for organization of taxpayer. Accordingly, taxpayer may use the alternative rates applicable to new corporations in computing its excess profits tax. *Fuller-White Chevrolet Co.,* DC Okla., 12/27/57.

Section 722 relief not available to magazine publisher. A pulp magazine publisher which came into existence after December 31, 1939, computed its excess profits tax credit on the basis of invested capital. It then sought a high excess profits credit based upon a constructive average base period net income, under the provisions of Section 722(c)(1), (2) and (3). The court denies the relief requested because of the corporation's failure to meet any of the qualifying conditions specified in the statute. *Crestwood Publishing Co., Inc.,* 29 TC No. 85.

Not entitled to earnings experience of "selling corporation" for EPT credit. Since taxpayer, a corporate auto dealer, failed to acquire "substantially all the properties (other than cash) of another corporation" and was therefore not a "purchasing corporation" within the intent of Section 474 of the 1939 Code, the Tax Court held it could not utilize the earnings experience of the "selling corporation" in computing its excess profits credit based on income. This court affirms. *Daniels Buick, Inc.,* CA-6, 1/23/58.

Casualty insurance company failed to prove base period earnings were an inadequate standard. A casualty insurance company which commenced business in 1928 claimed excess profits tax relief under Section 722(b)(4) on the grounds that as a relatively new company it must be deemed to have commenced business immediately prior to the base period years, 1936 to 1939, and, as a consequence, its average base period net income was an inadequate standard of normal earnings. The court concludes that taxpayer is not entitled to relief since the net income for the base years had actually reached a fairly constant level. Also, the fact that the company deducted a reserve for losses during the base years rather than the amounts subsequently developed as representing actual losses, is found not to have resulted in an inadequate standard of base period normal earnings entitling it to relief under Section 722(b)(5). *Northwest Casualty Co.,* 29 TC No. 64.

TAX ASPECTS OF ESTATE PLANNING

Estate & gift taxation

EDITED BY JOSEPH TRACHTMAN & J. A. MANNING

Spouses estates equal: consider advantages of marital bequests plus gifts

THE SMART ESTATE PLANNER takes it as fundamental that consideration must be given, not only to the total tax payable in transmitting property, but also to the time the tax payments are likely to be made. But, of course, this factor is given little weight when the planner is considering the estates of a husband and wife, both of whom are of advanced years. This was the situation discussed by Paul F. Icerman in our February column (8 JTAX 66). We have received a very interesting analysis from Jack Schlosser, of the New York CPA firm of Eisner & Lubin, of what may be the more typical situation of spouses with an age differential. He points out the effect of gifts by the surviving spouse and that planning to have the surviving spouse make gifts can result in estate tax savings.

The situation with which Mr. Icerman was concerned was a man who has an estate of about $1,000,000. "He has been rather tax-conscious over the years, managing the family finances in such a manner that his wife also has about the same amount of property. Both are over 70 years of age. Each has willed the entire estate to the children. I have not suggested that the wills be changed to utilize the marital deductions, although there could be a sizeable reduction in tax at the death of the first. However, chances are that both deaths will come fairly close together. The saving to the first estate would be offset by an even greater tax on the second."

Marital deduction costs $22,500

"At first blush," says Mr. Schlosser, "there would seem to be little or no discussion that could be held with regard to the foregoing conclusion. I have prepared a tabulation which illustrates the point being made. Exhibit A shows the results to the children upon the death of both taxpayers without a marital deduction provision in either will. Exhibit B shows the results to the children assuming the existence of a marital deduction provision in the will of the first decedent.

"It is obvious from these tabulations that the existence of a marital deduction provision has cost the children approximately $22,500 of additional estate taxes.

"The only point of discussion would seem to me to be whether or not Mr. Icerman's conclusion can be applied generally to all situations where a husband and wife have equal estates. Secondly, we should explore whether it is a fixed conclusion even under the slightly restricted set of facts which he has indicated."

"In the more typical situation," Mr. Schlosser reminds us, "the husband is generally older than the wife. Mortality tables indicate that members of the weaker sex live to riper old ages than their respective mates, as a general rule. If you combine these two aspects, you will generally have a situation in which it can reasonably be assumed that a time lag will exist between the death of the husband and wife. In this situation, then the results reflected in Exhibits A and B take on a different meaning.

"It is true that the marital deduction provision has cost the family $22,500; it is also true that this additional cost produces an offsetting advantage; namely, the deferral of approximately $177,000 of estate taxes until the second death. It is obvious that, if the reasonably anticipated interval between deaths is long enough, the possible payment of additional estate taxes of $22,500 may represent a reasonable cost for the use of $177,000 of tax money. If you add to this picture the possible pressure that may be exerted on businesses or investments held by the decedent in order to

EXHIBIT D — MARITAL DEDUCTION AND SURVIVOR'S GIFT IN CONTEMPLATION OF DEATH

Estate of first decedent	$1,000,000	
Marital bequest	500,000	
	$ 500,000	
Estate taxes	126,500	
Net retained by children		$ 373,500
Gift by surviving spouse	$ 418,000	418,000
Gift tax	82,000	
Total expended by surviving spouse	$ 500,000	
Estate of second decedent	$1,000,000	
Gift in contemplation of death	418,000	
Total	$1,418,000	
Estate tax	$468,000	
Gift tax credit	82,000	
Net estate tax	386,600	
Balance	$1,031,400	
Eliminate gift in contemplation of death	418,000	
Net retained by children		613,400
Total received by children		$1,404,900

raise estate taxes, we can easily see other reasons why the deferral of estate tax payments may be worth substantially more than the $22,500 reflected in the aforementioned schedules.

"If we assume that the security of the surviving spouse may be of greater importance to the testator than the ultimate enrichment of his children, we have still another factor which would tend to make the deferral of estate taxes a highly desirable aim.

"From all of the foregoing, it would appear obvious that one cannot always asume that the existence of a marital deduction provision in a situation where both husband and wife have equal and substantial estates is an undesirable situation. As a matter of fact, it is my strong feeling that in most instances, it is still highly desirable."

Gifts by surviving spouse

"There is one additional factor which may tend to dramatize the fact that the existence of a marital deduction provision in this type of situation can be turned into a definitely favorable tax factor. Exhibit A shows the results to the family after the death of both husband and wife where each has an estate of $1,000,000 and no marital deduction provision in either will. I will suggest two possibilities to amend this situation:

"1. A marital deduction provision is inserted in both wills with the property passing to the surviving spouse outright;

"2. Immediately after the death of the first taxpayer, the surviving spouse makes a gift to her children af $418,000 out of the property received from the first decedent.

"This will result in a gift tax of approximately $82,000 so that the surviving spouse has completely given away the full $500,000 which she inherited by way of gift or by way of gift tax. Exhibit C reflects the results of this situation after the death of the second decedent.

"It indicates two interesting conclusions:

"1. Under the initial set of facts in Exhibit A, the first estate tax to be paid amounted to $303,500; under the suggested set of facts in Exhibit C, the first estate tax, plus the gift tax, amounts to $208,500, thereby indicating a deferral of $95,000.

"2. The final results indicate that the children have been enriched in the second situation by the same amount; namely, $95,000. This is, of course, entirely due to the fact that the gift tax paid in the foregoing situation is cheaper than the estate tax that would have been paid on it in the original situation.

"Thus, it can be seen that the marital deduction provision, coupled with a gift, can result not only in tax deferral with all of its attendant benefits, but can result in ultimate over-all savings. In this illustration, the gift tax was calculated on the assumption that the lifetime exemption of the surviving spouse had been fully utilized. It also made no provision for annual exclusions. It is obvious, therefore, that there are possibilities that this gift tax cost can be further reduced with increased benefits to the entire family."

Contemplation of death?

"What if the surviving spouse complies with this program and then dies within three years of the gift? Under such circumstances, it is possible that the gift may be held to have been made in contemplation of death and therefore includible in the estate of the surviving spouse for purposes of calculating the

EXHIBIT A – NO MARITAL DEDUCTION

Estate of first decedent	$1,000,000	
Estate taxes	303,500	
Net received by children		$ 696,500
Estate of second decedent	$1,000,000	
Estate taxes	303,500	
Net received by children		696,500
Total received by children		$1,393,000

EXHIBIT B – MARITAL DEDUCTION

Estate of first decedent	$1,000,000	
Marital bequest	500,000	
	$ 500,000	
Estate taxes	126,500	
Net received by children		$ 373,500
Estate of second decedent	$1,500,000	
Estate taxes	503,000	
Net received by children		997,000
Total received by children		$1,370,500

EXHIBIT C – MARITAL DEDUCTION AND GIFT BY SURVIVOR

Estate of first decedent	$1,000,000	
Marital bequest	500,000	
	$ 500,000	
Estate taxes	126,500	
Net received by children		$ 373,500
Gift by surviving spouse to children	$ 418,000	418,000
Gift tax	82,000	
Total expended by surviving spouse	$ 500,000	
Estate of second decedent	$1,000,000	
Estate taxes	303,500	696,500
Total received by children		$1,488,000

second estate tax. Putting aside for the moment the fact that this position can be resisted and that taxpayers have been fairly successful in overcoming this point of view, does it represent a possibility for upsetting the happy conclusions noted in Exhibit C?

"Exhibit D measures the results of this situation. It presupposes the first death with a marital deduction provision; a gift by the surviving spouse; the payment of gift tax thereon; the death of the second spouse coupled with the inclusion in his or her estate of the aforementioned gift as having been made by him in contemplation of death.

"Exhibit D indicates clearly that this position by the Treasury Department will reduce the over-all tax savings to the family by approximately $85,000. However, there is still an over-all savings of $10,000 and the benefits of deferring tax upon the first death in the amount of $95,000. This would seem to indicate that, in this instance, at least, the inclusion of the marital deduction provision, coupled with the gift, is a definite advantage even if the Treasury Department takes the adverse position with regard to the gift." ☆

New estate & gift decisions this month

Widow's power of appointment too restricted to qualify for marital deduction. The residue of taxpayer's estate was left in trust for his wife, who was given a power to appoint the corpus by her will. The court finds that, under state law, she had no power to appoint her estate or her creditors; it follows that this power is too limited to qualify for the marital deduction. *Allen*, 29 TC No. 52.

Decedent had no power despite attempted appointment. In 1903 taxpayer, a nonresident alien, created a trust, the principal to go to her child if only one survived her; if more than one survived she had a power of appointment. She attempted to exercise this power even though only one child survived her. The court holds she had no power of appointment and therefore the trust corpus is not includible in her U. S. estate. The vesting of the corpus in her only child came about as a result of the trust terms, not a power of appointment. *Brooke Trust (Bank of N. Y. Tr.)*, DC N. Y., 11/26/57.

Grantor not taxable on income of trust created between "May v. Heiner" laws. Decedent's husband was obligated to pay his first wife $9,000 a year and he established a trust for this purpose. When he died, decedent (his second wife) became entitled to the property subject to the first wife's rights. In January 1932 she transferred her interests to another trust in which she reserved the income rights but irrevocably disposed of the remainder. Such a transfer, if made today, would in any event be includible in the gross estate as a transfer with income retained for a period not ascertainable without reference to decedent's death. The court held it was likewise includible under the law applicable to transfers between March 3, 1931, and June 7, 1932, because of the retained right to receive income in excess of $9,000 a year for life, although in fact there was no income in excess of $9,000 in any year. This court reverses; the trust was not producing $9,000 a year income. The right to excess income was therefore "without substance"; her right to income after the first wife's death was merely contingent and not taxable in this period. *Hubbard Estate*, CA-5, 12/6/57.

Extent of power to invade charitable remainder presents a question of fact. Decedent's will made provision for a trust, the income from which was to go to certain relatives for their lives, with the remainder to charity. The trustee had the discretionary power to invade principal for the benefit of the life tenants as he should deem to be "reasonable and proper." The Commissioner disallowed the charitable deduction on the ground that the bequest could not be measured with sufficient accuracy. After securing a state court judgment to the effect that the power of invasion was to be exercised only for the support and maintenance of the life tenants, the executors brought this suit for refund. The Commissioner's motion for a summary judgment is denied. Although the state court proceedings, being nonadversary, are not binding here, the ambiguity in the will as to the extent of the trustee's power, and the possibility of its exercise, must be determined by evidence extrinsic to the will itself. *Capewell Estate (Hartford Nat'l Bank & Trust Co. Ex'r)*, DC Conn., 11/20/57.

Alien's undrawn trust income a deposit free of estate tax. The Code exempts from U. S. estate tax deposits in the U. S. by a nonresident alien, not engaged in business. Decedent had been the income beneficiary of a trust of which a U. S. bank was trustee. The court holds that the unremitted income balance at the date of death was due her without restriction and was a deposit exempt from estate tax. *Brooke Trust (Bank of N. Y. Tr.)*, DC N. Y., 11/26/57.

Insured's estate includes policies; wife's checks don't prove she paid premiums. Decedent's wife paid half the insurance premiums on decedent's insurance policy with checks from her bank account. However, the Tax Court finds, she did not show that decedent did not give her the money to pay the premiums. It holds that in the absence of such proof the entire proceeds of the policy are includible in the gross estate. *Wolf Estate*, 29 TC No. 46.

Intrafamily notes barred by the statute not an estate debt. Decedent during his lifetime borrowed money from his four children and his wife, for which he gave them promissory notes. The Tax Court allows the notes held by two of the children as claims against the estate, but disallows the notes of the others because the statute of limitations would bar their collection. *Wolf Estate*, 29 TC No. 46.

Date of creation of revocable trust determines date power of appointment is created. General powers of appointment created prior to October 21, 1942 are taxable only upon their exercise by the donee. Here decedent's husband had created two inter vivos trusts, in 1935 and 1931, respectively, under which decedent was granted a general power of appointment. One of the trusts was revocable by the grantor, and, under the terms of the other, the decedent's power was contingent upon her surviving her husband. She did in fact survive her husband, but her own will made no mention of the powers. The court holds that, despite the fact of their contingency and revocability, the powers were created at the time of the creation of the trusts, that is, prior to October 21, 1942. Con-

sequently, decedent's failure to exercise them makes them nontaxable. Under the law of Alabama, a residuary clause does not operate as an implied exercise of a power of appointment. *Turner Estate (Merchants Natl. Bank of Mobile, Ex'r.),* DC Ala., 11/21/57.

Employee's estate includes death benefits; he could name beneficiary (Old Law). Decedent possessed enforceable vested rights to income in pension plans and a profit-sharing trust set up by his employer. He could be deprived of his rights only by voluntarily terminating his employment or by being discharged for cause. He also had the right to designate a beneficiary of the payments in the event of his death before or during the period payments were to be made. He died in 1951, having named his wife as beneficiary of the as-yet-unenjoyed payments. The rights constitute a property interest, includible in his gross estate at their date of death value. In addition, his power to designate a beneficiary constituted a general power of appointment, and the value of the payments is includible as appointive assets. [The 1954 Code excludes an annuity under a qualified plan receivable by a beneficiary other than the employee's estate.—*Ed.) Wolf Estate,* 29 TC No. 48.

Legal life estate with power of disposition does not qualify for marital deduction (Old Law). Decedent bequeathed his entire residuary estate to his wife "to be used, enjoyed and disposed of by her in any way she may choose" with a proviso that any unconsumed portion should pass upon her death to their son. Under the law of Kentucky, this language created a life estate, with a power of disposal. Under the 1939 Code, such an estate was considered a "terminable interest," and the marital deduction is denied the estate. [Section 2056(b) (5) would now permit a legal life estate with an unlimited power of disposition, whether exercisable by will or inter vivos, to qualify for the marital deduction.—*Ed.*] *Boyd Estate,* DC Ky., 11/8/57.

Retained interest in notes valued. Decedent had given away an undivided fractional interest in notes during her lifetime, but had not given the assignees a preferred claim. The district court held the value of her retained interest is the same proportion of total value as the face amount retained is of total face amount. This court affirms. *Howells,* CA-10, 12/19/57.

Withdrawals from estate without court decree not illegal; no claim arises. Under the terms of the will of decedent's husband she was to be sole beneficiary if she survived distribution of the estate; if she did not, their children would be beneficiaries. Decedent served as executrix from the time of her husband's death in 1939 until her death in 1951. During this time she repeatedly made substantial withdrawals from the estate without obtaining a decree therefor from the probate court. The district court held that a state court would have been obligated to confirm the withdrawals, and therefore no deductible claim would arise against her estate because of her administration of her husband's estate. This court affirms. *Howells,* CA-10, 12/19/57.

Charitable deduction allowable though unpaid taxes may reduce bequest. Decedent's will provided for a trust for the benefit of his wife with powers of invasion and appointment. The residuary estate was left in trust to certain charities, and all death taxes were to be paid out of this trust. Pennsylvania inheritance tax on the widow's trust was only $24,000, but Pennsylvania authorities reserved the right to collect an additional tax in the event the widow failed to appoint the remainder, so that it would go to charities not exempt from the Pennsylvania tax. The Tax Court allowed the charitable deduction but held that since additional Pennsylvania interitance taxes might ultimately be due and payable out of the residuary trust, the deduction should be reduced by the possible amount of such additional state taxes. This court affirms. *Brooks Estate,* CA-3, 1/9/58.

Husband's life insurance not includible in wife's estate, even though purchased with community funds. The Commissioner included one half the cash surrender value of 26 insurance policies on the life of decedent's surviving husband in her estate on the ground that the premiums had been paid with community property and decedent had been named primary beneficiary if she survived her husband. The court holds that such inclusion would be inequitable, since the executor would have to pay a tax on property which had not come into his possession. In addition, the only interest the decedent had in the policies was a right under state law to prevent one half the proceeds from being paid to a stranger upon the death of her husband without her consent; otherwise her husband had complete control of the policies. This interest of the decedent was extinguished by her death, nothing was transferred, and consequently nothing is includible in her gross estate. *Stewart Estate,* DC Calif., 12/18/57.

Election of alternate valuation date binding despite erroneous legal advice. The election to use the alternate valuation date must extend to all of the property included in the gross estate, not only to the portion of such property which has declined in value. The executor in this case, however, was informed otherwise by his attorney, with the result that he signified his election to use the alternate valuation date in the manner prescribed on the return form, but entered date of death values with respect to those items wihch had appreciated in value, and, for those which had fallen in value, the value one year from the date of death. The aggregate value of the estate assets had actually increased during the year after death. The court holds that, since the intention to elect the alternate valuation date was unambiguously expressed, the election was irrevocable, and the estate tax was to be paid on the basis of the enhanced value. *Beaston Estate (Rosenfield Ex'r),* DC Penna., 12/3/57.

Marital share of residuary estate is computed prior to the allocation of estate taxes. Decedent left half of his residuary estate to his widow and half to his children, and further provided that taxes be paid out of the residuary estate, rather that out of specific legacies or bequests. New York law provides that taxes are to be apportioned according to the value of the property received, with allowance made for any exemptions or deductions allowed for the purpose of arriving at the value of the taxable estate. The question presented the court is whether the amount of the marital deduction should be reduced by the widow's proportionate share of the taxes, or whether the full marital share, be-

Notes on new estate and gift decisions in this department are by Edward P. Hannigan, member of the New Jersey Bar and associated with Harrison F. Durand in Newark.

fore such reduction, should be used in computing the taxable estate. The court holds that, under New York law, the benefit of the marital deduction is to be computed on the widow's share without reduction for taxes apportionable thereto, thus giving the entire benefit of the marital deduction to the widow, rather than to the residuary estate as a whole. *Ransom Estate (Prezzano, Ex'r)*, DC N. Y., 12/30/57.

Interest is not payable on refunds under Technical Changes Act of 1949. The Technical Changes Act of 1949, which provided for refunds, under certain conditions, of estate taxes paid upon transfers taking effect at death, contained a provision that no interest was to be paid on such refunds. Taxpayer here argues that this provision related only to administrative refunds, not, as in his case, to overpayments which are recovered through court order. The court in denying interest was allowable holds that no such distinction is made in the act, which had, in effect, conferred upon certain taxpayers, retroactively, a benefit which was a pure windfall. *Cardeza Estate* DC Penna., 12/24/57.

Power of appointment released in contemplation of death; trust corpus included [*Certiorari denied*]. Decedent, through a nominal settlor, set up a spendthrift trust in 1929 under which she reserved a life estate and a general testamentary power of appointment. Under the mistaken impression that she would thereby avoid the estate tax, the decedent released her power in 1943. The court holds that the general power of appointment constituted a reserved power to alter, amend or revoke the transfer and that, estate tax avoidance being her sole motive, it was released in contemplation of death. Consequently, the trust corpus was includible in decedent's estate. *McIntosh Estate*, cert. den., 1/13/58.

One half the value of survivorship annuities purchased with community funds includible in gross estate. Decedent had purchased a number of annuity contracts under which she was to receive a certain sum annually for life, commencing at a stated age. Any portion of the purchase price unrecovered at her death was to be paid to her husband, with their daughter a contingent beneficiary. In 1950, the terms of the contract were changed to provide for equal monthly payments to the decedent over a period of 20 years, any remaining payments to be made to her daughter upon the mother's death prior to the expiration of the period. Since the contracts cannot be considered insurance policies for estate tax purposes, they are not taxable under the insurance sections of the Code. Under the law of California, there was a presumption that the contracts were community property, since they had been purchased with community funds. Consequently, the decedent possessed at her death an interest in the policies equivalent to only one half their value, except as to those in which the husband had expressly released his community interest, leaving the policies clearly her separate property and as such fully includible. In either case, the aggregate amount to be received had to be discounted to show the value as of the date of death. *Stewart Estate*, DC Calif., 12/18/57.

Husband's gift of property not reduced by wife's failure to release inchoate dower. Taxpayer made a gift of real property to his children; his wife did not join or otherwise release her inchoate dower. The Service rules that her failure to release does not diminish the value of the property for gift tax purposes. *Rev. Rul.* 58-13.

Donees liable for gift tax though on other gifts. The Commissioner determined that a deficiency in gift taxes was due from the donors of trusts set up in 1951, but the three-year statute of limitations barred collection from that source. Within one year after the statute had run on the donors, however, the Commissioner gave notice to the trustees that a gift tax was due on the property they held in trust. Each donee is held responsible to the extent of the value of his gift for the gift tax due on all of the gifts made by the donors during the taxable year in question, regardless of whether he held the specific property as to which the gift tax was assessed. It makes no difference that the donors were solvent and that no attempt had been made to collect the tax from them. *La Fortune*, 29 TC No. 54.

Discretionary trusts for minors not entitled to annual exclusion (Old Law). Taxpayer created irrevocable trusts for the benefit of each of his six minor grandchildren. Any part of the income or principal of the trusts, or both, could "be used at any time it may be needed" for the support, comfort and education of the income beneficiary. This discretion lodged in the grantor, while living, and in the trustee upon grantor's death. The court holds that the annual exclusion of $3,000 per donee is not available, since only future interests were created. It was not possible to value the beneficiaries' present right to either corpus or income at the time of the gift. [Under the 1954 Code, exclusion is allowed for a gift in trust for a minor even though invasion may be made for the minor if the remaining principal will go to the donee at 21 or to his estate.—*Ed.*] *Street*, 29 TC No. 46.

Power to invade bars annual exclusion for value of income interests (Old Law). A series of trusts were set up through the years 1951-1954 for the benefit of the minor children of the taxpayers. In all four series of trusts, income was currently payable to the beneficiaries or their guardians, the trusts to terminate upon the beneficiaries' attainment of their majorities. Two of the trusts contained provisions authorizing discretionary invasions of corpus by the trustees. As to such trusts, no $3,000 exclusions were allowable, since, the court holds, the income interests, subject as they were to the power of invasion, could not be valued. The two trusts not providing for invasion of corpus qualified for the annual exclusion to the extent of the value of their income interests. None of the remainder interests qualify for the annual exclusion because they are future interests. [Under the 1954 Code, exclusion is allowed for a gift in trust for a minor even though the principal may be invaded for him, if the remaining principal will go to the donee at 21, or to his estate.—*Ed.*] *La Fortune*, 29 TC No. 54.

Unlimited power to invade principal for the benefit of grantor prevents a completed gift [*Nonacquiescence*]. Decedent had set up an inter vivos trust, the income from which was payable to her for life, with remainder to named beneficiaries. The corporate trustee had the power to invade trust principal for the "comfort, education, maintenance or support" of the grantor. There was testimony by an officer of the corporate trustee that the insertion of this power for the protection of the grantor had been a condition of their acceptance of

the trust. The Tax Court held that no gift was payable, since there was an unlimited power of withdrawal held by a nonadverse party, and consequently no completed gift. *Gramm Estate,* 17 TC 1063, *prev. acq. withdrawn; nonacq.* IRB 1957-49. Similarly *Paolozzi,* 23 TC 182, *prev. acq. withdrawn, nonacq.* IRB 1957-49; *Vander Weele,* 27 TC 342, *nonacq.* IRB 1957-49.

Waiver of restrictions on assessment does not bar refund claim under Technical Changes Act of 1949. When decedent died in 1942, an estate tax was paid by his executors on the value of an inter-vivos trust under which the decedent had retained a reversionary interest, although one whose value was less than 5% of trust corpus, the law in effect at that time requiring such inclusion. The executors at that time filed a waiver of restrictions against immediate assessment and collection of deficiency in estate tax in order to stop the accumulation of interest. Pursuant to the Technical Changes Act of 1949, which provided for refunds of taxes paid on such transfers as the present one, the executors in 1950 sought a refund of the amount paid. The court holds that they are entitled to it. The waiver of restrictions filed with the Collector of Internal Revenue did not constitute a closing agreement or compromise of the tax due, since the Commissioner was not thereby precluded from asserting a further deficiency, and consequently the executors are not estopped. *Dunk,* DC Fla., 1/28/58.

Restriction on power of invasion disqualifies bequest. Decedent left the residue of his estate in trust, the income being payable to his wife on demand, and provided further that she could invade corpus if she should require additional sums and that "she and she alone shall be the judge of how much shall be required." The Tax Court held that the wife possessed a general power of appointment over the trust which qualified for the marital deduction. This court reverses. Under the applicable state law, the wife's invasion of principal had to be made in good faith and was limited to her reasonable needs. Consequently, it did not qualify as a general power of appointment. However, two separate interests were created by the trust; the other portion to the extent unconsumed, was to pass absolutely to the wife's estate upon her death. The value of interest was a valid marital deduction. *Ellis,* CA-3, 1/31/58.

Wife may permit husband to manage her property, but it remains hers [*Acquiescence*]. Decedent had for a long time prior to his death been in poor health, while his wife had been extremely active in a number of business ventures. In 1936, his wife purchased a liquor store with her own funds. Decedent's feelings of inadequacy and insecurity prompted his wife to permit him to manage the store finances. The decedent utilized some of the proceeds of the business to set up bank accounts in his own or assumed names. He also maintained safe deposit boxes and had an account with stockbrokers. Title to two parcels of real estate was recorded in the decedent's name. The Tax Court rules that the assets found in the possession of the decedent at the time of his death, being the proceeds of the business owned solely by his wife, were her property and not includible in his gross estate. *Rand Estate,* 28 TC 1002, *acq.* IRB 1958-7.

Bequest to Bar Association charitable. Testator bequeathed $5,000 to the Rhode Island Bar Association to be used by it "for the advancement and upholding of (the) standards of the profession . . . and for the prosecution and punishment of those members who violate their obligations to the court and to the public." The Commissioner denied a charitable deduction on the ground that the bequest was an outright gift to a noncharitable organization which engaged, at least to some extent, in the carrying on of propaganda and other activities intended to influence legislation. The court finds that there was no evidence that a substantial part of the activities of the Bar Association involved attempts to influence legislation. In any event, the gift was not outright, but in trust, and for the specific purpose of maintaining the ethical standards of the legal profession. The court holds that this purpose comes within the designation "charitable" and that consequently the bequest qualifies for the deduction. *Rhode Island Hospital Trust Co.,* DC R. I., 1/22/58.

Transferee's enjoyment of principal not dependent upon surviving transferor. Decedent transferred interest-income certificates to his wife in 1941 and 1942, providing that the income was to be paid to her during her life and that she could at any time terminate the arrangement by withdrawing the principal amount represented by the certificates. Should his wife predecease him without having exercised the power of termination, the income was to be paid to him for life with a similar power of termination. The certificates are not includible in the decedent's gross estate by reason of his express reservation of a reversionary interest. Possession or enjoyment by the beneficiary could be had, not only by surviving the decedent, but also by the beneficiary's exercise of the conferred power of termination. *Smith,* DC Colo., 12/30/57.

Requirement that widow survive distribution void; marital deduction allowed. Decedent bequeathed his entire residuary estate to his wife, but with the proviso that, in the event she should die before distribution of the bequest, the property was to pass to others. The Commissioner contended that the contingency requiring her survival until distribution created a possibility of divestment which could occur subsequent to the six-month period following the testator's death, and that consequently the bequest failed to qualify for the marital deduction. The district court disagrees. An examination of the applicable state law leads the court to the conclusion that, by reason of the rule favoring early vesting of estates, the condition subsequently attached to the initial gift was void and that the widow's interest, being as a consequence indefeasible, qualified for the marital deduction. *Smith,* DC Colo., 12/30/57.

No charitable deduction though sole beneficiary died leaving all to charity. A husband and wife executed reciprocal wills. Each left the entire estate to the other, if surviving. If not, the entire estate, after certain bequests, was to be paid to a charitable trust. The husband died first, and during the period of administration the wife died. The husband's estate claimed a charitable deduction for all the income of the estate subsequent to the wife's death since it would ultimately go to the charitable trust established under the wife's will. This court affirms the disallowance of the deduction. The charitable deduction is available only when it is the decedent's will that commits the income to charitable purposes. *Williams,* CA-9, 1/24/58.

NEW DEVELOPMENTS IN

Payroll taxes

EDITED BY PETER G. DIRR

The problem of equity v. speed in disputed unemployment insurance

THE OLD SAW "justice delayed is justice denied" applies with particular aptness to unemployment insurance benefit cases. Denial of benefits pending court settlement of the unemployed worker's right to disputed payment would put on him an almost irresistible pressure to surrender. The solution adopted in many states is to require payment if the worker's right to it has been upheld twice. Frequently, if the payment is ultimately held to be unjustified, the employer's account is not charged. Yet even with this provision, these "double affirmation" clauses have been found unconstitutional by a number of state courts. (See, for example, the criticism of the Pennsylvania case *Pennsylvania State Chamber of Commerce* v. *Torquato* at 6 JTAX 356.)

A comprehensive note in the University of Pennsylvania Law Review (106 U. Pa. L. Rev. 256) evaluates the problem, the solutions adopted by the various states and the treatment given these solutions by the state courts. This article is an adaptation of that paper, omitting the footnotes.

Nature of interests involved

The primary objective of unemployment compensation is to alleviate the financial stress placed upon an unemployed worker, says the law review. In order properly to effectuate this policy, payments must be made as soon as possible after unemployment arises. However, the attempt to do so may adversely affect certain interests of the employer whose workers are to receive the benefits, depending upon the procedure adopted.

Instead of requiring all employers to contribute a uniform percentage of their payrolls to the unemployment compensation fund, all states now employ some type of sliding scale based upon unemployment experience of the individual employer. Of the five types of "experience-rating" systems in use, all but one reflect the amount of benefits paid to a particular employer's workers in the determination of his contribution rates. Under the "reserve-ratio" plan, the most popular experience-rating device, memorandum accounts are created for each employer. Used solely for measuring the risk of unemployment, they do not represent an actual equity in the fund. However, since an agency's allowance of benefits is charged to the employer's memorandum account, which in turn is the most important factor in determining his contribution rates, his economic interest in the account becomes real.

Although the amount of benefits paid is important in determining contribution rates under experience-rating formulas, contribution rates are also affected by the total balance of the general pooled fund out of which payments are made. The Pennsylvania statute, for example, provides for five separate rate schedules, each of which goes into effect at a predetermined fund balance, and operates to set contribution rates after the employer's experience rating has already been determined. The contribution rates increase as the fund's balance decreases.

In addition to the employer's interest in the effect disbursements may have upon future contributions, his interest as a taxpayer in seeing that the fund is properly disbursed has been heavily relied upon by those cases holding double affirmation clauses unconstitutional. This interest becomes especially important in claims arising out of labor disputes if the jurisdiction is one which prohibits payments in such cases or prohibits those arising from strikes as contrasted with lockouts. Improper agency allowance of benefits may place the employer in the anomalous position of supporting, through his own contributions, workers who are striking against him. Failure to permit interposition of the employer may frustrate the legislative attempt to prevent use of unemployment compensation as a tool in labor-management bargaining.

Due process ramifications of double affirmation clauses can best be understood in light of the alternatives available to the legislature.

At the one extreme, all payments might be made subject to prior judicial review of the administrative determination. This procedure affords maximum protection to the employer, but concomitantly works to the detriment of the employee because of the probable increase in time between the creation of unemployment and the payment of benefits. Under the present Pennsylvania system the two separate administrative appeals alone may require ten weeks, with the time period extended to over four months if judicial review is required.

No judicial review

At the other extreme from a procedure staying payment prior to judicial review would be one precluding judicial review entirely. While this method would clearly facilitate quick payments, it would offer the employer a minimum amount of protection. As a result of agency action alone he might be subjected to higher contribution rates both through charges to his experience-rating account and a decrease in the fund balance, as well as to harm through improper disbursement of the fund to striking workers. If payment upon double affirmation but with eventual judicial review poses due process questions, *a fortiori* this procedure would raise constitutional problems.

Limited judicial review

In the middle ground are those procedures permitting immediate payment upon agency determination, but providing for eventual judicial review. If judicial review results in agency reversal, aside from suspension of further payments, three results may follow: the employee may be forced to disgorge prior payments, thus returning the fund to the status quo; or the employee may be permitted to retain prior payments without adjustment in the employer's memorandum account; or the employee may be permitted to retain prior payments,

but with an adjustment made in the employer's memorandum account, thus restoring that account to the status quo.

Were the employee forced to disgorge prior payments upon reversal of the agency decision, the employer would suffer no harm: both the fund balance and his memorandum account would be restored to their proper level. Furthermore, improper disbursement would have a less serious effect upon the employer's bargaining position in a labor dispute. If the employee knows that he is charged with repaying awards reversed upon judicial review, or that he will at least be subject to a judgment that might result in attachment of property he may acquire in the future, he will be more prone to settlement than if such awards were made free and clear.

However, the impact of recoupment upon the employee renders this alternative unpalatable. In all probability he will already have spent payments made. Recoupment would, therefore, have to take the form of either requiring equal reductions from payments due the particular employee when he is unemployed in the future or requiring payment from whatever other assets he might have.

Suspension of payments upon judicial reversal of an agency award, but without recoupment and without adjustment of the employer's experience-rating account, would satisfy the employee insofar as he could retain prior payments. But the employer, of course, would be adversely affected by unreviewed agency action to the extent such payments force an increase in his contribution rates. A procedure of this sort was held unconstitutional as a deprivation of due process in *Pennsylvania State Chamber of Commerce* v. *Torquato*. (See box). The Pennsylvania act provides for no recoupment unless the employee is at fault in receiving payments to which he is not entitled. Although it was argued that an employer's experience rating would not be charged if the agency's allowance was reversed upon judicial review, the court did not so construe the act.

The third alternative would provide for adjustment of charges to the employer's experience-rating account, but not for recoupment of payments already made. Thus, the only injury to the employer through increased contribution rates caused solely by administrative action would be that resulting from a decrease in the general fund balance. The employer would argue that a decrease in the fund balance would either result directly in a higher rate or would prevent the fund's balance from building up to a level permitting decreased rates. However, since there may be a large range in fund balances before a new rate schedule becomes effective, it would be difficult for the employer to demonstrate that any individual payment had more than a *de minimis* effect upon contribution rates. And neither could the employer claim special injury, since a rate change resulting from fluctuation in the fund level would affect all employers paying into the fund in the same manner.

Thus, this procedure would appear to be the most reasonable compromise available to the legislature since it minimizes injury to the employer caused by unreviewable administrative action, yet facilitates rapid payment of compensation without subjecting workers to the hardship of recoupment. Nevertheless, this procedure has met with judicial opposition on the ground that it amounts to a usurpation of judicial power to review administrative action and consequently is a denial of procedural due process.

Denial of due process

Any determination of whether limited preclusion of judicial review violates procedural due process must take into account the protection which the administrative process itself affords the interested parties. Administrative agencies have been criticized by some for being "incautiously careless of litigants' rights in ways that fair-minded judges would have avoided." More specifically, it has been suggested that agency personnel may be more vulnerable to political pressures than the judiciary and that the agency may not be able to attract men whose ability is equal to those attracted to judicial service. In addition, agency work is subjected to less effective public scrutiny than is that of the judiciary.

Supreme Court on due process

The Supreme Court has indicated that due process may be sufficiently flexible as to permit limited preclusion of judicial review under special circumstances where there is a compelling need for such preclusion. For example, under the Selective Training and Service Act of 1940, the President was authorized to establish civilian agencies, including local and appeal boards, to carry out the drafting of civilians for military service. Civilians were classified by the local board and could appeal these classifications to an appeal board. The act made no provision for judicial review.

In *Estep* v. *United States* (627 U. S. 114 (1946)), in which petitioner was in-

STATE LAWS ON CONTESTED PAYMENTS

THIRTY STATES and the District of Columbia provide for payment of unemployment compensation upon double affirmation (Alabama, Arizona, California, Colorado, Florida, Georgia, Idaho, Iowa, Kentucky, Louisiana, Maine, Maryland, Mississippi, Missouri, Montana, New Hampshire, New Jersey, New Mexico, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Wyoming).

Of these states, eleven have no special provision concerning *supersedeas* (Alabama, California, Colorado, Kentucky, Maryland, New Hampshire, New Jersey, Ohio, Rhode Island, South Dakota, Virginia), fifteen grant it only if the agency so orders (Arizona, Florida, Georgia, Iowa, Louisiana, Maine, Massachusetts, Missouri, Montana, New Mexico, North Carolina, Oklahoma, South Carolina, Tennessee, Wyoming), and four states and the District of Columbia specifically deny it (Idaho, Pennsylvania, Texas, Utah).

Of the remaining states, two provide for payment upon double affirmation except for claims arising out of labor disputes (Illinois and Minnesota), two provide that payment upon double affirmation is within the agency's discretion (North Dakota and Wisconsin) and two require payment if an appeal board affirms a referee's allowance (New York and West Virginia). Six states prohibit payment upon double affirmation (Arkansas, Connecticut, Delaware, Indiana, Kansas and Michigan), while five have no provision concerning such payment (Massachusetts, Nevada, Oregon, Vermont, Washington). In one state payments are made if allowed by an appeal tribunal (Nebraska).

dicted for refusing to submit to induction, the Court sustained the defense that the board had acted beyond its jurisdiction. In so doing, however, the Court severely limited the scope of judicial review of board classifications. The question of jurisdiction was said to be reached "only if there is no basis in fact for the classification which [the board] gave the registrant." The fact that a board's classification was erroneous was not subject to attack.

The special circumstance thought to justify the circumvention of judicial review in the selective service area was the "urgent need of mobilizing the manpower of the nation for emergency purposes and the dire consequences of delay in that process. . . ." Although the Court did not allow complete preclusion, its due process holding is particularly significant in light of the questionable need for preclusion and the fact that the petitioner's personal liberty was at stake.

In the Emergency Price Control Act of 1942, the Court was faced with a legislative attempt to preclude judicial review of administrative price determinations for a limited period. The act provided for promulgation of maximum prices by an administrator. The prices so set could be protested to the administrator by an aggrieved party, and a denial of such a protest by the administrator could be appealed to the Emergency Court of Appeals. However, neither this court nor any other could stay, prior to review, the effectiveness of the administrator's price regulation once it was set. The Court said in *Yakus* v. *United States* (321 U. S. 414 (1944)), that if the alternatives "were wartime inflation or the imposition on individuals of the burden of complying with a price regulation while its validity is being determined, Congress could constitutionally make the choice in favor of the protection of the public interest from the dangers of inflation." Thus the prohibition of a temporary stay or injunction was held not to be a denial of due process in that situation. Such injury as was caused during the interim period would be irremediable.

Application to unemployment awards

Similarly, in the case of unemployment compensation awards, if the alternatives are ineffectiveness of unemployment payments because of delay, or imposition of the "burden" of complying with the administrative determination while its validity is being determined, it would seem that the legislature should constitutionally be able to make the choice in favor of the latter. Particularly does this appear reasonable where the statutory scheme provides for adjustment of the employer's experience-rating account, thus minimizing the impact upon his economic interests resulting from unreviewed agency action. The strong need for preclusion, the insubstantial effect on the employer's interests, and the protection afforded by the administrative process combine to dictate a holding that procedural due process is not violated. And it is likely that a Federal court on the basis of the *Estep* and *Yakus* cases would so hold.

Nevertheless, the courts in some states have already declared double affirmation clauses unconstitutional. [See box in adjoining column.—*Ed.*] In some of the cases the decision was based in part on the due process clause of the applicable state constitution. Since these state due process clauses may be interpreted more stringently than the Federal provision, it appears that double affirmation statutes may be found invalid in other states where they have not yet been challenged. Assuming that rapid payment is still considered necessary by the legislature, an alternative method of speeding payment is to limit the scope of review.

In those jurisdictions finding preclusion of judicial review unconstitutional, the courts do not indicate what scope of review is required. In light of the interests involved and the protection afforded those interests at the administrative level, the way seems open for a limited scope of review. Thus, the statute might provide for immediate payment upon double affirmation, without provision for judicial review except in those cases where there is an act in excess of the agency's jurisdiction or an alleged procedural unfairness, involving, for instance, lack of adequate notice or arbitrary and capricious action by the agency. ☆

CASES ON DOUBLE AFFIRMATION

Double affirmation clauses in unemployment compensation statutes were first subjected to judicial scrutiny in 1941. In holding the provision valid, the California court, in *Abelleira* v. *District Court of Appeals* (17 Cal. 2d 280), decreed that immediate payment was a legislative mandate not to be contravened by the courts and found no violation of due process therein. In this same year two other jurisdictions reached a contrary result. The Iowa court concluded that since *supersedeas* was left to the discretion of an agency under the Iowa statute, the agency was permitted to exercise the judicial power to grant or withhold an injunctive order, thereby violating that state's separation of powers doctrine (*Dallas Fuel Co.* v. *Horne,* 230 Iowa 1148). Michigan, in *Chrysler Corp.* v. *Smith* (297 Mich. 438), invalidated the clause, claiming it would "render administrative action superior to recognized judicial powers" and make due process of law "nugatory and a senseless gesture." One year later the same court, in *Chrysler Corp.* v. *Unemployment Compensation Comm'n* (301 Mich. 351), specifically rejected the *Abelleira* decision in reaffirming its own stand. In ensuing years Indiana struck down the clause (*State ex rel. Campbell* v. *State,* (223 Ind. 59) while West Virginia upheld it (*State* v. *Davis,* 131 W. Va. 40) and Texas avoided the issue on procedural grounds (*Todd Shipyards* v. *Texas Unemployment Comm'n,* 245 S.W. 2nd 371). Two contemporary decisions have done little to resolve the problem. The Pennsylvania court, after a detailed analysis of the property interest involved, declared the clause violative of due process (*Pennsylvania State Chamber of Commerce* v. *Torquato,* 386 Pa. 306), while Oklahoma, after distinguishing its statutory scheme from that of Pennsylvania, reached the opposite result (*Abraham v. Van Meter,* 303P.2d434).

Indiana sick pay deductible

HERE is another change in the status of sick pay for state tax purposes. In the chart which was printed in 8 JTAX 117 sickness payments made to residents of Indiana were shown as not deductible. The Indiana tax authorities have now issued Information Bulletin No. 58-2 dated March 3, 1958, stating that, if sickness payments are made in accordance with an employer's specific plan, they are excludible from gross income. This would seem to indicate that total payments under the employer's plan are to be considered to be non-taxable. ☆

TAXATION OF

Partnerships

EDITED BY JACKSON L. BOUGHNER, LL.B., CPA

Partnerships still have tax advantages; Casey compares with use of corporation

PRIOR TO THE ADOPTION of the income tax splitting benefits of the Revenue Act of 1948, the family partnership was a hot subject of discussion whenever tax men gathered. Since that date, we have seen very few articles on this subject.

It was with great interest, therefore, that we read William J. Casey's book "How to Handle Taxes in a Law Practice."* In Chapter Two of this book he discusses the pros and cons of corporation v. partnership. He sets forth the basic advantages of the partnership as follows:

"Net tax cost may often be less in a partnership than a corporation. Income splitting for married couples gives the partner the benefit of lower tax rates on all partnership income. Stockholders can split only salary and dividend income. Note, too:

"The corporation distributes its profits in the form of dividends. These profits are also taxed to the stockholders. While the new dividends received credit grants some relief from the double tax, it is still a long way from being eliminated altogether. Partnership earnings are not taxed twice. There is only one tax on each partner's share of the profits.

"Corporations are penalized by a tax if they accumulate earnings without distributing them to the owners. Here, again, the 1954 Code granted some relief — by allowing at least $60,000 to be accumulated without question and by making it tougher for the tax authorities to claim that there is an unreasonable accumulation. But, again, the danger has not been entirely eliminated. The partnership won't run into this difficulty. The partnership can accumulate its earnings at will.

"You decide how to divide profits among your partners without regard to investment. You can even do it at the end of a year.

"Income may be exempt to the corporation (for example, proceeds on sale of property below cost, proceeds of life insurance, canceled debts, etc.). But it is fully taxed when distributed to the stockholder. That is not so with partners.

"Earnings already taxed increase the cost basis of the partner in his company. That is not true of the stockholder.

"If the owner is also employed by the corporation, he may have to draw a salary in loss years in order to justify its reasonableness in other years. Thus, he will have taxed income although the business does not show a profit.

"Long term gains are taxed at only 25% to the partner, and to the corporation. But they lose their identity when paid as dividends by the corporation. Then they are taxed to the limit.

"Partnership losses can be offset against personal income. This can also yield the carryover and return of the prior years' taxes.

"Partners' drawings are not subject to unemployment insurance.

"Capital losses of partnership business reduce capital gains of individual partners in preparing tax returns. This is not true in corporations.

"Partners (not true of stockholders) can deduct their share of partnership charitable contributions (30% of their adjusted gross income) while corporations are limited to 5%. Partners (not true of stockholders) can also take their share of tax-free interest as exempt income instead of as taxed corporate distributions."

Depreciable property

To the above partnership advantages should be added one which is not clearly spelled out in Mr. Casey's book. That is the situation in which a partnership is formed to own and operate property which is subject to substantial allowances for either depletion or depreciation. When such property is owned by a corporation, it is the corporation that gets all the tax advantage out of the depletion or depreciation and, except in rare instances, distributions to the shareholders will generally be taxable in full. Under corporate ownership, there is also the disadvantage that the corporate tax must be paid on any net income and only the balance is subject to distribution.

Where such property is owned by a partnership, however, the members of the partnership will receive income from the property, and will become entitled to whatever the amount of the depletion or depreciation is. Thus, if, for example, the cash income from rent of an apartment building is $50,000 and the depreciation is $25,000, in effect the owners will be receiving $50,000 of income which is taxed at one-half the regular rates.

In some cases, the depreciation or depletion may exceed the taxable income from the property, in which case the advantage of a partnership is obvious. With the new depreciation rules, such as double-declining balance and sum of the year's digits, the possibility of using a partnership to own and operate newly constructed property should be considered whenever the construction of such property is planned.

Limited partnerships

Mr. Casey goes on to discuss limited partnerships as follows:

"Limited partnerships have been more and more used to permit investors to do two things. First, they can give a deduction of the losses as they are incurred — an ordinary deduction, rather than a capital loss, which arises when there is a stock loss. Next, they secure limited liability — usually the amount contributed.

"Assume a person of wealth wants the ordinary loss, but wishes to limit his liability. He is approached by another without funds. Usually two or more of the latter people organize a general partnership. The investor is then given a limited partnership. His investment then may:

"Be first used to cover all losses of the partnership, if any arise — or losses may be shared proportionately.

"Give him some large percentage of profits, if they occur — or profits can be

* *How to Handle Taxes in a Law Practice*, by William J. Casey, New York, Institute for Business Planning, Inc., 1957, $12.50, 228 pages.

first used to pay back the limited partner's losses.

"Sometimes limited partnerships contract with corporations to run their businesses. They may agree that the limited partnership is to get some large percentage of profits, if ever earned, and to assume all or part of the losses, if they are incurred; or is to operate a business in all of its departments and to pay over a piece of the profits to the corporation, but the corporation is to pay no losses."

In this connection, we should point out that the general partner should have a financial interest in the property. As pointed out in an article in this department of a few months ago, if the general partner is a man of limited financial means, the IRS may take the position that the partnership is in effect an association taxable as a corporation and just a cloak to protect the limited partners from liability.

The limited partnership has been growing in use lately in connection with the ownership of rental property where it is desired to permit the owners to deduct the depreciation on their own returns. Generally the leader in the group acquiring the new property will act as the general partner and the investors will go along as limited partners.

Family partnerships

It was Mr. Casey's discussion of family partnerships and their tax advantages even under the income tax splitting rules that struck us as particularly pertinent. Under the heading "How to Use Family Partnerships," he states as follows:

"Family partnerships are more important than ever today—mainly due to recent changes in the law permitting us to set them up by gift. That can give us an easy way to split family income with children, parents and others in the family. This splitting can be much more favorable than that secured by whacking up the corporate stock by gift in many instances.

"The 1954 Revenue Code specifically permits us to set up a valid family partnership by gift or purchase even though the partners render no services. In many cases, the family partnership has become clearly preferable to the closely-held corporation from a tax standpoint. In years gone by, the refusal by the Bureau to recognize many of these partnerships for tax purposes made for great caution in taking advantage of the tax savings possibilities offered by the family partnership. Now, by meeting a clear-cut set of standards, we can use this method of dividing business income and the build-up of capital, too, with children and other members of the family, IRC 1954 Section 704(e).

"Family Partnership Tax Savings and How They Accumulate: You may be startled at the accumulation of annual income tax savings plus the estate tax saving which can result from creating a family partnership. The tables below will give you an idea of the annual income tax saving and the cumulative build-up over 20 years, together with the additional tax saving at death. The tax savings are estimated at levels of business income ranging from $25,000 to $300,000 a year. We assume that a father makes a gift of a one-third partnership interest to each of his two children and that the father will report 50% of the partnership income (25% for services and 25% for capital—split up on a joint return with his wife) and the children report 25% each. The tax savings and the children's income accumulate at 2½% compound interest. The estate tax savings are estimated at a 30% rate.

"Tax savings will be greater if more individuals are taken in as partners. Take these recent cases:

"Twelve children, eight of whom contributed no services, were OK'd as partners with a $22,000 saving. (*Lankford v. Dunlap*, DC Texas, 5/30/52.) Three brothers spread 60% of their business interests among ten trusts for their children, nieces, nephews, unmarried sisters. In fourteen years $700,000 was shifted to 29 taxpayers. (*Mauritz v. Scofield*, CA-5 Texas 206 F.2d 135).

"How the Tax Savings Develop. There's a sizable savings in shifting income from high tax brackets to lower brackets. For example:

"Mr. A, a married man with one child, owns a sole proprietorship that yields an income of $50,000 after exemptions and deductions. Even with income-splitting, the top $6,000 is taxable at 50%, the next $4,000 at 56% and so on. Mr. A changes the business to a partnership and gives his son an interest that transfers $10,000 of business income to the son.

"For tax purposes, the $10,000 now shrinks to $8,400—the son is entitled to his own $600 exemption and at least a $1,000 standard deduction. And the amount is subject to taxes ranging from 20% on the first $2,000 to 34% on the last $400. True, the father may lose an exemption because his son's income is more than $600. That loss, $354, is more than offset by the $3,112 tax reduction from shifting the $10,000.

"In addition, the creation of a family partnership avoids estate tax on:

"1. The value of the capital interest transferred to children and, if we keep under the $60,000 exemption and the $6,000 annual exclusion for each donee, we get no gift tax.

"2. The build-up on value of partnership capital and earning power.

"3. The income which accumulates in the hands of the children."

Obviously, to take advantage of a family partnership, a man must have a family. He must also be willing that they share in his income during his lifetime. Many owners of closely held corporations are constantly seeking advice on how to increase the amounts they are paying to their children and how to make gifts of corporate stock to their children. Often the problem is presented of two or three children working in the business and two or three who are not working in the business. Usually the father would like to benefit all of his children equally, whether they work in the business or not. Many sons-in-law have been hired to work for corporations simply so as to benefit the daughter.

In a family partnership, a great many of these problems are eliminated. Each of the children can receive his fair share

Table of Tax Savings Effected by Use of Family Partnership

Net Business Income	*Tax as Proprietorship*	*Family Partnership Tax*	*TAX SAVINGS Each Year*	*Over 20 Years*
$ 25,000	$ 5,672	$ 4,491	$ 1,271	$ 33,279
50,000	18,294	12,308	5,986	156,731
75,000	33,860	23,600	10,260	268,638
100,000	51,192	37,414	13,778	360,749
150,000	89,586	68,630	20,956	548,691
200,000	131,682	103,392	28,290	740,717
250,000	176,114	140,868	35,246	922,816
300,000	220,614	180,306	40,308	1,055,384

in the property and those who are actually working there can, in addition, receive a salary. No problems of reasonable salary are presented, provided salaries are paid only to those who actually work for the business.

We have seen many instances lately in which family partnerships have produced substantial tax savings for the owners. In none of these situations would we recommend that a corporation be substituted for the family partnership. Mr. Casey's discussion indicates clearly that the principal problem is one of arithmetic. The income from the enterprise should be determined and then the taxes thereon, either in a corporation, sole proprietorship or in the family partnership, should be computed. The estate taxes that would be payable were the property to remain in the ownership of the head of the family should also be taken into consideration. ☆

New partnership decisions this month

Reserve on incorporation of partnership really a debt. When taxpayers incorporated their partnership assets, they set up a "contingency reserve" of $7,000 to cover any unascertained claims. The corporation took over all partnership assets and assumed the liabilities, but no claims were presented to be charged against this reserve account. When the limitations period against such claims had expired, the corporation distributed the $7,000 to taxpayers. The court holds the reserve account represented a debt to taxpayers and the distribution was a repayment, not a dividend. *Burck,* DC Ind., 1/28/58.

Land contributed to partnership takes basis of contributing partner. Taxpayer was a 50% member of a partnership in the business of developing unimproved real estate. He contributed land to the partnership having a cost basis to him of $9,800, and which was carried on the partnership books at $28,000. When the land was sold, the partnership reported distributable income using a cost basis figure of $28,000. The court holds taxpayer's true distributable income from the partnership was one-half of the profits from the sale of the transferred land computed on the basis of the cost of the tract at $9,800, and not $28,000. [Under the 1954 Code it is possible for the partnership to provide for the taxation of the entire appreciation which occurred prior to contribution, but was realized after, to the contributing partner.—*Ed.*] *Culley,* 29 TC No. 113.

Distributable partnership income taxable to each partner up to date of termination. Two brothers, Harry and William, conducted a scrap metal business as equal partners and reported the partnership income on a calendar-year basis. Their association was not harmonious and, after many proposals and counterproposals and several notices of dissolution of the partnership, Harry, by agreement dated April 21, 1951, sold out his interest to William for $125,000, a price arrived at by reference to the January 1, 1951, status of the business. On the facts as shown, the court concludes that the partnership continued in full force and effect until it was terminated by the April 21, 1951, agreement and up to that date Harry was a full 50% partner in every respect and taxable on half of the distributable income. *Est. of Goldstein,* 29 TC No. 99.

Court reverses finding on motion to reopen record and holds son a partner. In a prior decision the court had concluded that three out of four children were bona fide partners with their parents in a brokerage business. With respect to the fourth child, it found that there was insufficient evidence to establish that he was a partner. Now, upon a reconsideration of the original record and the receipt of additional evidence, including testimony of the fourth child, the court reverses itself and holds the latter did receive a valid and completed gift of a partnership interest and that he was a bona fide partner. The court notes that its action in granting the motion to open the record is exceptional and not to be regarded as a precedent in view of its general policy not to try cases piecemeal. *Willett,* TCM 1958-20.

Misc. New Decisions

Needn't deduct contributions in computing depletable income. Taxpayer was entitled to percentage depletion, the allowance being a percentage of its net income from the property. The Commissioner insisted that contributions to certain local hospitals and charities were really business expenses and reduced the depletable net income. The court, referring to the many cases holding similar contributions were allowable only as charity because the company and its employees received no special benefit, agrees with the taxpayer that the amounts here are allowable only as contributions and do not reduce the depletion allowance. *U. S. Potash Co.,* 29 TC No. 112.

Capital gain on sale of oil rights; deduction for intangibles allowed. Taxpayer partnership transferred oil rights to drilling companies under an agreement whereby it was to bear 55% of the drilling costs and to receive 55% of the oil income. The drilling company made a cash payment for its 45% interest. The court holds that the cash payment from the oil company is capital gains. It allows deduction of depreciation and intangible drilling costs as claimed. [No opinion reported and the exact nature of the controversy is not clear.—*Ed.*] *Fasken,* DC Tex., 12/13/57.

Stripper can't accrue estimated cost of required land fill. Taxpayer, a strip mining company, was required by state law to restore stripped properties within one year after the mining operations were completed. During the taxable years involved, the company did not complete mining, nor did it contract for the restoration work on any of its stripped properties. It did, however, charge off on its books as an accrued expense the estimated future cost of restoring the properties stripped during the year. Since nothing occurred during any of the taxable years to give rise to a liability for the expenses, the court holds they were not "incurred" and hence could not be allowed as deductions. The court also points out that even if the expenses were properly accruable, they would have been disallowed because there was no showing that the amounts estimated were reasonably accurate. *Denise Coal Co.,* 29 TC No. 61.

Erratum: It grieves us to have to invite attention to an error in our last issue. We mentioned that Arch M. Cantrell had just been named General Counsel of the Treasury Department. As practically everybody knows, he is Chief Counsel of the IRS.

TAX PLANNING AND

Business management

EDITED BY CHARLES S. LOWRIMORE, Sr., CPA

Planning needed now to take advantage of possible tax relief for small business

PRESSURE IS INCREASING for tax relief for small business. Tax men serving these smaller businesses would be well advised now to make their plans such that they can benefit from relief when it becomes law. How likely is tax relief for small business?

In every session of Congress hundreds of tax bills are introduced; some are reasonable and practical, others almost fantastic. All but a very few lack powerful backing and have no chance of passage. Generally it is enough for the tax man to keep an eye on the activities of the Ways and Means Committee and the Senate Finance Committee—since, ordinarily, only bills sponsored by them are likely to become law. But in the present political situation the pronouncements of the Senate Committee on Small Business must be heeded—their tax recommendations are likely to have a good chance of passage. Congress, like the country at large, is disturbed by signs of recession and is inclined to try the effect of a tax cut—probably done in such a way as to aid both consumer purchasing power and the survival of small business.

The Committee (see membership in box) makes some specific suggestions for changes ranging from (1) a universal tax-deductible retirement plan to (2) depreciation changes, or (3) to require the Commissioner either to follow the Tax Court or appeal. These recommendations are embodied in a bill (S. 3194) which is given the title, *The Small Business Tax Adjustment Act of 1958*.

Reinvestment allowance

The Committee proposes that a tax allowance be made for profits reinvested in a business. Since depreciation would not be allowed on this investment, the proposal amounts to immediate expensing of the investment. "The purpose of a provision of this kind," it said, "is to provide the equity capital for development of small business, which is so badly needed. The allowance to be provided for reinvestment can be tailored to benefit only the concerns which are in need of and may use such funds. This proposal would avoid the problem of defining 'small business.' It would assist all business concerns, regardless of size, but it would give relatively greater relief to the small.

"An allowance for reinvestment would permit a deduction for income tax purposes for any business, regardless of its form of organization, which increased investment in inventory or depreciable assets out of income. The allowance should be permitted on a graduated scale which would require the taxpayer to assume full responsibility for a portion of the expansion. It is suggested that the allowance be made according to the following scale:

"Amount of investment permitted as allowance:

50% on first $10,000 eligible investment

30% of $10,000 to $20,000 of eligible investment

20% of $20,000 to $30,000 of eligible investment

This would permit a maximum annual allowance of $10,000 for a firm investing $30,000 or more in eligible assets. The maximum of $10,000 is large enough to give relief to concerns which are most in need of increased equity investment.

"In order that this provision might not be misused, several concerns with the same ownership should be considered and taxed as a single unit in order to take advantage of this allowance.

"Further safeguards against abuse of this proposal which your committee suggests are (1) that to the extent of reinvestment in depreciable assets the allowance be applied to same; (2) that no deduction for depreciation be permitted for tax purposes, to the extent of the allowance permitted, on assets against which the allowance has been applied; and (3) that, on sale of a business in which the allowance has been taken, or on the sale of an individual asset or group of assets on which the allowance has been applied, any gain on sale be considered as ordinary income to the extent of the unexpended accumulated allowance."

Fast write-off of used equipment

"Witness after witness," the Committee said, "testified to a discriminatory provision in the 1954 Internal Revenue Code which works a wholly unintended hardship. The purchasers of "used" equipment or facilities have been denied the advantage of the alternative methods of depreciation provided by section 167. Used property is purchased most often by smaller concerns which cannot afford new machinery. There seems to be no reason why the same methods of depreciation should not be available to the purchasers of property to be used in a trade or business, whether it be new or used."

Allow $100,000 accumulated earnings

The penalty tax on unreasonable accumulation of surplus is another area of the tax law which, the Committee felt, bore heavily on the closely-held corporation. "This group," the Committee said, "has great problems in accumulating equity capital for ordinary business needs . . . The greatest share of such expansion has historically been financed through retention of earnings. Not only is it difficult to retain enough earnings after taxes, but management of small corporations must always prepare to defend the reasonableness of their accumulation. This additional burden is not thrust on larger, public owned corporations, because the Treasury has considered broad public ownership to be an automatic deterrent to improper accumulation of surplus.

"In order that small business might be relieved from the more onerous restrictions imposed by the accumulated earnings tax, your committee suggests an amendment . . . whereby the minimum accumulated earnings credit be increased from $60,000 to $100,000

which will take some of the pressure off the smallest of corporations, who are most restricted presently. The amendment will cause little, if any, loss of revenue to the Federal Government, will provide some increased equity financing for small corporations, and will relieve a great psychological deterrent to the development of small business."

Election to be taxed as partnership

"A corporation should be permitted an election, upon agreement of its stockholders, to be taxed as a partnership. Such an election must necessarily be binding, not only on the corporation but a corporate successor. It is the purpose of such an election to permit the taxpayer to operate in one form but be taxed as if another, thereby allowing the taxpayer the least possible tax.

"For purposes of administering this provision properly, it would be necessary to make the election binding for a definite period, to prevent constant jumping back and forth. Still, in view of the purpose of the provision to give the taxpayer the benefit of the least tax payable under the most favorable form, your committee would not suggest a permanent election. Conditions change over a period of time, which might well change the basis for such an election. Therefore, it is recommended that such an election be binding on a corporation for a period of 4 years, after which a new decision might be made.

"Your committee also suggests a correlative amendment to section 1361 of the 1954 Internal Revenue Code [the election of proprietorships and partnerships to be taxed as corporations.—*Ed.*] The election permitted by that section should also be subject to a new decision after 4 years. In addition, section 1361 should be amended so as not to be limited to partnerships 'in which capital is a material income-producing factor, or 50% or more of the gross income of such enterprise consists of gains, profits, or income derived from trading as a principal or from buying and selling real property, stock securities, or commodities for the account of others.' This last change will extend the benefits of this section to many worthy enterprises."

Passage-of-title rule

The Committee cited at length the testimony of one witness about the heavy expense the current passage-of-title rules put on a small business attempting to qualify as a Western Hemisphere trade corporation. That witness, as quoted by the Committee, said:

"Although section 109—now section 921—contained no express definition of the source of income for Western Hemisphere trade purposes, the Treasury regulations provide that . . . the source of income from the purchase and sale of personal property is the country in which the property is sold. The courts have held under section 119 that such place of sale, and therefore the source of income, is the country where title to the personal property passes. The Commissioner of Internal Revenue has adopted these holdings and ruled them to be applicable to the Western Hemisphere trade corporation section.

"It will be noted, however, that the basic purpose underlying section 119 was to determine the jurisdiction of the United States to tax income, whereas the purpose underlying the Western Hemisphere trade corporation section, as stated at the time of its adoption, is to eliminate competitive disadvantages between United States corporations dealing with South American customers as against foreign corporations.

"In order to accomplish this latter purpose, it would appear that the place where the competition exists should determine the source of the income.

"In view of the state of the law, it was necessary, under the Commissioner's interpretation of section 109, that [my] company establish operating procedures so that title . . . would pass outside of the United States.

"However, the expense of establishing and maintaining such warehouses or branch offices, particularly during the early years of the establishment of South American trade, would have been prohibitive. The possibility of obtaining agents in South America to whom shipment could be made and who would transfer title was investigated, and again it was determined that this expense and complication could not be justified from a sound business or competitive standpoint. It was also obvious that the intervention of a branch office, warehouse, or agent would contribute nothing toward furthering the congressional purpose in enacting the Western Hemisphere trade-corporation section and would merely add complication and expense. It would therefore appear logical that the simplest, least expensive means of transporting the property to its ultimate destination would be most desirable to effectuate the congressional purpose.

"It is impractical for small companies to maintain branch offices or warehouses in all of the many South American countries. Like ourselves, many of these other smaller companies make special equipment for our South American customers, and any warehouse, branch office, or business arrangement merely for the purpose of establishing the fact that the title passed outside of the United States is cumbersome, expensive, and contrary to the purposes of the original act."

The Committee made no specific suggestions for changes; it said merely that "Foreign trade by smaller concerns is as important to this country as trade by bigger businesses. Such trade may even be more important to the continued existence and good health of small business. Legislation permitting equal application of the Western Hemisphere trade-corporation provisions to small business should be passed immediately."

No rate reduction

The Committee felt that an over-all rate reduction would cause too great a cut in the revenues at this time. It said: "Many witnesses at each of the cities in which hearings were conducted suggested that over-all rate reduction of individual and corporate income taxes would be of the greatest possible assistance to the economy. These people would reduce both the personal and corporate income-tax rate to a maximum of 42% on a step basis over a 5-year period.

"Your committee feels that this suggestion is much too broad and all-encompassing for it to pass judgment at this time. It does appear that such a plan would entail a loss of revenue to such an extent that few if any other changes could be made. It well may be asked if the inequities should be removed before such a costly wholesale operation is undertaken which would serve to perpetuate discrimination within the system."

Personal retirement allowances

"It has long been evident that persons eligible for membership in pension, profit-sharing, or stock-bonus plans, as provided for by section 401 of the Internal Revenue Code of 1954, were

Select Committee on Small Business

THE UNITED STATES SENATE Select Committee on Small Business consists of the following members: John Sparkman, Alabama, Chairman; Russell B. Long, Louisiana; Hubert H. Humphrey, Minnesota; George A. Smathers, Florida, Wayne Morse, Oregon; Alan Bible, Nevada; William E. Proxmire, Wisconsin; Edward J. Thye, Minnesota; Leverett Saltonstall, Massachusetts; Andrew F. Schoeppel, Kansas; Barry Goldwater, Arizona; Thomas H. Kuchel, California; Jacob K. Javits, New York; Walter B. Stults, Staff Director; William J. Erickson, Counsel; and Wiley S. Messick, Counsel.

highly favored by the drafters of tax legislation. Only these people have been assisted, by favorable tax treatment, toward proper provision for their declining years. This is a most worth-while purpose to be fostered by tax legislation, but it is wrong that most taxpayers are discriminated against by not being permitted equally advantageous tax treatment.

"This discrimination causes several unfortunate consequences to the small businesses of the country. Small businesses are less able to set up and maintain plans which will qualify for the preferred treatment under section 401. This is true because the professional expense and overhead charges of such plans will not be spread over as large a group of employees and, thus, will be relatively more costly even where it is used. Many are the small employers who simply may not set up such a plan because of the excessive cost.

"When an employer does not have a retirement plan—so-called fringe benefit—he finds himself at a great disadvantage in competition for employees. Even should he pay higher wages equal to a competitor's wage and retirement benefits, he would find that, because of the favorable wage and retirement benefits, the applicant would be money ahead by going with the larger firm. He must expend more just to make equal payment to the employee. Then there is the psychological advantage of a pension plan, even if equal economic benefit is offered.

"More importantly, most of the small businesses of this country are not incorporated. An operator of an unincorporated business may not be an "employee" for the purpose of membership in a qualified plan under section 401. Thus, the individual proprietor, unlike his counterpart in the corporate organization, may not get favorable treatment for himself, even if he chooses to set up a plan for his employees. This is a factor which looms large in any determination to provide such a plan.

"For these and other reasons, professional and self-employed groups have for some time been attempting to get equal treatment for their members. Bills have been introduced in both Houses of Congress to accomplish this. Your committee has examined the provisions of these proposals and heard testimony on their relative merits.

"Your committee suggests a provision which, although not new in concept, is new in technique and breadth of application. It would permit all taxpayers of this country the opportunity under the tax laws to provide for their own retirement.

"It would seem essential that such a provision include all persons not now eligible for membership in a 'qualified plan' who are now given favored treatment. All taxpayers covered would be subject to the same application of this proposed amendment to the 1954 Internal Revenue Code.

"Each taxpayer would be permitted a deduction for an amount up to 10% of his taxable income, or $1,000, whichever is the lesser, if invested in a prescribed manner. The investment of such funds would necessarily have to be in a way which would take them out of the control of the taxpayer and apply them solely for the purpose for which the deduction is given. Such investment could be made with a bank or insurance company in special restricted accounts or policies. The recipient financial institution would be required to make regular reports to the Internal Revenue Service concerning all such deposits or accounts.

"This would provide a rather simple and workable plan whereby the taxpayer would be relieved of taxes on reasonable sums set aside for his own retirement. The taxpayer would, however, be required to pay taxes on all amounts received by way of benefits under his own program after retirement.

"Because of the nature of this proposal, your committee would suggest a method by which a taxpayer would be entitled to carry over an unused portion of his retirement deduction for use at a later time. This would make allowance for emergencies, which make equal annual deposit impossible. Further, in order that today's older taxpayers may take advantage of this deduction, it should be provided that persons over 50 be allowed a progressively greater allowance, depending on their age. The purpose of these last two modifications is to extend equal benefit to as many taxpayers as possible.

"A retirement deduction of this nature would largely eliminate a very discriminatory feature in the tax system. Your committee does not consider revenue loss a controlling factor, because what is fair treatment for one group of taxpayers should not be denied to the rest."

Deferring estate tax

"Your committee suggests that certain qualified estates be permitted an absolute election to pay the Federal estate tax in installments over a period of up to 10 years and a further extension to 20 years where hardship can be shown. Estates which would qualify for the absolute election would be those which had more than 50% of their assets tied up in a closely held business, whether it be organized as a proprietorship, partnership or corporation.

"As a further safeguard it should be provided that a disposition of the nonliquid portion of a qualifying estate would make the unpaid balance of the estate tax immediately due and payable. This would also be the case where any installment payment on the tax was missed by the estate."

Administrative matters

"Inconsistent interpretations of the Internal Revenue Code, resulting from the non-acquiescence of the Treasury in judicial rulings, work hardship on small business. Ordinarily, the amounts of tax are smaller, and, in many cases, not worth the expense of litigation. It is most difficult for a taxpayer to understand why the Treasury continues to press a position in defiance of a contrary ruling by the Tax Court or a United States Court of Appeals. This is especially true when it costs the taxpayer an additional amount in tax not great enough to repay the cost of contesting.

"Your committee wishes to commend the Treasury for its recent better record in acquiescence and its continuing effort

to reduce to the very minimum the number of cases in which appeal of acquiescence does not follow an adverse decision of the Tax Court. However, it would seem that here is an area where Congress should, for the benefit of all taxpayers, compel acquiescence in responsible judicial determination.

"An amendment to the Internal Revenue Code to compel acquiescence by the Treasury in judicial determinations need not be too confining or restrictive to be of value. The Treasury ought not to be able to dispute decisions of the Tax Court or a United States Court of Appeals except by direct appeal to a higher court. The Treasury would be protected by its right of appeal, and the taxpayers—both the one in litigation and those others involved with the same question—would gain the advantage of finality and uniformity of treatment.

"Where different courts have handed down inconsistent rulings, the most recent Court of Appeals decision, as compared to one of the Tax Court or an earlier decision of a court of appeals, ought to be followed by the Department unless the Department seeks an appeal. This would assure uniformity of administration and adequate protections for the taxpayer without an undue hardship on the Department.

"It was most disconcerting to find that much of the criticism of the tax system was leveled not at the way the law was written by Congress, but the manner in which it is being administered. Your committee recognizes the difficult task of the Treasury in trying to please people while taking their money. But there have been some complaints, supported by chapter and verse, that indicate that the Treasury has been less than 100% responsible in administering the law as Congress wrote it.

"In the Internal Revenue Code of 1954, Congress provided that a proprietorship or partnership might elect to be taxed as a corporation under certain circumstances. In providing for the election, Congress stated ". . . an election may be made, in accordance with regulations prescribed by the Secretary or his delegate. . . ." The manner and method in which the election could be made was expressly left to the Secretary. Naturally, the normal working regulations governing the administration are much more important for a new provision such as this, than for a section much like one contained in the earlier law. In spite of their importance, today, some 3½ years after Congress acted, the Treasury still has not proposed the final regulations for this section.

"Testimony was received from professional tax consultants that they dared not advise their clients to make an election under section 1361 until they had had an opportunity to see the final regulations. Since the election is irrevocable, they wanted to know the full effect of the election before binding their clients. Even though the temporary regulations left an escape clause for those choosing to be taxed as corporations, until final regulations are promulgated, the lack of definitive regulations is all-important in advising a client to set up a new bookkeeping system which may turn out to be worthless.

"The full circle was completed when it was argued to the House Ways and Means Committee in 1957 that section 1361 should be repealed because it had not been effective, as proved by the fact that it had not been used. Thus, a section enacted by Congress for the benefit of small business has been rendered useless by the failure of the Treasury to issue regulations. It has been and will be argued that final regulations had to be rewritten for the whole code after the 1954 revision and thus it cannot be helped. However, most of the regulations have been proposed in final form, even though, in most respects, the law—and, therefore, the regulations—is almost the same as the 1939 Code. It would seem that a little more care might have been shown for this particular section which was intended by Congress to benefit a hard-hit area and which was noticeably ineffective without the regulations.

Discrimination toward small firms

"Another example of administrative discrimination toward small concerns is exemplified by a statement submitted at the Minneapolis hearing:

" 'I am particularly concerned by an apparent new concept in taxing stock redemption by small-business corporations and which, if broadly enforced, will result in great tax inequity and an impossible tax burden on small corporations.' " The witness went on to explain that the Treasury was arguing that a redemption of stock of another stockholder was a dividend to him.

" 'This concept, I am told is supported by two recent cases of the Tax Court of the United States (*Joseph R. Holsey*, 28 TC No. 107, August 1957, and *Louis H. Zipp*, 28 TC No. 32, May 1957). This redemption has not increased my present net worth in any sense and the "constructive dividend" so-called is nonexistent.

" 'To my way of thinking, this new concept cannot help but result in killing off any incentive to let small corporations grow. Shareholders, who are also employees, will want to withdraw earnings in the form of salaries rather than to expand their business, realizing that any expansion will result in a greater tax to them when any shareholder dies or wants to withdraw.'

"Much testimony was heard concerning the Treasury's new use of salvage value for the purpose of determining proper depreciation schedules. This also is being done without the benefit of legislation and what, in many instances, appears to be an attempt to thwart the advantage granted by Congress in section 167 of the 1954 Internal Revenue Code, which allowed alternative methods of depreciation.

"The Treasury in each of these examples has set out to accomplish something not provided for by law and, in the last two instances, actually appears to run counter to the intent of Congress. It is also important to note that the impact of these administrative moves falls most heavily on the smaller concerns. These are only several of the many examples of this kind of administrative legislation reported.

"In the first instance, your committee wishes to condemn any activity which operates to negate a benefit intended by Congress. In instances cited in the above discussion, it is clear that Treasury has dragged its feet and operated to thwart the intent of Congress where provisions did not meet with Treasury approval. Regulations should be issued immediately so that section 1361 might become effective. Argument sustaining the absence of the regulations will not be nearly as effective as getting the regulations promulgated so that Congress can have an opportunity to determine the effectiveness of section 1361 for the purpose intended.

"Your committee, with other appropriate committees of Congress, will continue to watch the Treasury Department to see that legislation is administered in the way it was intended. Action should be quickly initiated where it appears that a provision is being ill administered. The will of the Congress must prevail."

INCOME TAXATION OF
Trust & estates

Tax benefits spur increased use of discretionary trusts

DISCRETIONARY TRUSTS are increasingly popular, tax men say, with the tax benefits they can provide undoubtedly a factor in their growing use. Fortunately, this is one area at least in which the tax law is working toward social good—discretionary trusts are frequently the most desirable way of providing for family needs. Don H. McLucas, vice president of the Northern Trust Company, Chicago, spoke on the legal and tax aspects of discretionary trusts at the recent Mid-Winter Trust Conference in New York.

Trust instruments prepared thirty or thirty-five years ago, he said, rarely included the power to pay principal to the income takers. Later, discretions were given trustees to advance principal to meet emergencies, such as accidents, illness, and operations. More recently, the yardstick has been enlarged to cover broader purposes, and in some instances eliminated altogether. During the past few years, the use of the discretion to distribute a part or all of the trust income among one or more beneficiaries has become exceedingly popular.

The tax laws have undoubtedly given the greatest encouragement to the use of these discretionary powers and to the use of the corporate trustee to exercise them. Particularly is this true as to the discretionary power to allocate trust income among a group of beneficiaries in the hope of minimizing family income taxes. A discretion to pay income in equal or unequal shares among a parent and children is a classic example. The parent usually has outside income and is in a much higher income tax bracket than the children. Often the parent is interested in providing financial assistance to the children when needed. Under a broad discretionary power over income, the financial assistance can be satisfied directly from trust income. The balance of the trust income can either be paid to the parent or accumulated, whichever would be in the parent's best interests. The allocation of the income among the family group in this manner will invariably result in minimizing income taxes chargeable against the trust income. The tax economics of this arrangement, as compared with an alternate plan which would direct payment of all income to the parent—the high-bracket taxpayer—with the understanding that the parent will provide for the needs of the children, is obvious.

This discretion to allocate income among the parent and children is sometimes used as an alternate to a proposal of "skipping a generation," which contemplates that there would be no provision in the trust settlement for the parent who has other expected sources of income, and that all income would be paid to the children, even though the parent may be living at the time of the payments. Inherent in the skipping plan is the possibility that the parent may be in need of funds some time in the future because of ill health or other unforeseen circumstances. If these future events should come about, the parent would be dependent on the children—a most unfortunate situation and completely opposed to the intention of the maker of the trust. Compare this plan with the discretionary trust arrangement which affords the flexibility to make income and principal available to the parent during his or her lifetime in case of need, and in the meantime permits income payments to be made to the children.

In recent years, the discretionary power over income is often used in the second trust under wills which qualify the first trust for the marital deduction. The wife must be entitled to all the income from the first or marital trust. This and her income from other sources may place her in a high income tax bracket and suggest that such income will be sufficient for her needs. A discretion in the second trust, permitting the trustee to allocate income among the wife and children, will serve to protect the wife in case she may have need for the income from this trust; at the same time, the prudent exercise of the power will undoubtedly have the effect of minimizing the tax payable on the income from this trust.

The tax laws encourage the use of an independent or corporate fiduciary to exercise the discretion to allocate income among a group of beneficiaries. The courts in a few cases have considered the taxability of trust income, actually paid to others, by a trustee who was one of the objects of the discretionary power. In each of these cases, the court determined the trustee-beneficiary not to be taxable on income paid to other objects of the power. In each case, however, the court found the discretion not to be unlimited in scope but restricted for certain purposes, such as "needs," "maintenance and support," "support and welfare" and "education." If the discretionary power of the trustee to pay income to himself and to others is very broad in scope and not limited to an "ascertainable standard," then the entire trust income, no matter to whom actually paid, will probably be taxed to the trustee-beneficiary. If, however, the beneficiary is acting with a disinterested co-trustee, then it appears from the Code that a broad discretion may be granted to the joint trustees without this adverse tax consequence. Quite often it is desirable to cast the discretion in the broadest kind of terms so as to give utmost flexibility in allocating income among the family group rather than to confine the trustee's allocation to enumerated purposes within which the power may be limited. In such cases a corporate trustee is often designated as the trustee or co-trustee to exercise such a discretionary power.

Precise rules laid down

The current Code contains precise rules as to the type of discretionary powers over income and principal that will cause income of an inter vivos trust to be attributable to the grantor even though actually paid to others. If the tax results planned to be accomplished

by irrevocable inter vivos trusts are to be achieved, these rules in many instances require the use of a disinterested trustee, which often means a corporate fiduciary, to deal with the discretionary powers. A power to allocate income among a family group such as a parent and children falls within the requirement of this particular set of rules. Whether encouraged by tax laws or prudent planning for the disposition of property, the use of discretionary powers over income and principal is growing at a greatly accelerated rate; and this growth gives every promise of continuing in the future. ☆

New trusts & estates decisions

Deduction allowed for estate income given to charity under will compromise. When decedent died in 1949, he left two wills, one of which gave a portion of the residue to charity. Under a compromise agreement made in 1950 the charities got a smaller fraction of the residue and it was agreed that the residue "shall include the net income of the estate." The administrator claimed a deduction each year for the fraction of the income that went to the charity. The Commissioner disallowed it on the ground that it was not received by the charity in satisfaction of a claim for *income*. The court allows the deduction; by the compromise agreement the charity had a right to the residue and a right to the income. Furthermore, as to 1949 income, while the amount was not paid or permanently set aside in that year, the deduction is allowable because it comes under the alternative words of the statute allowing deduction for amounts to be used exclusively for charitable purposes; that provision does not contain the phrase "during the taxable year." *Fitch Estate (Emanuelson, Adm.),* DC Conn., 2/4/58.

Annuity received in settlement of will contest is taxable income. In settlement of a contest over her grandfather's will, taxpayer agreed to the setting aside of certain assets in a trust to pay her some $200 a month for her life. The district court held that the payments were made to taxpayer from income of the trust and they are taxable to her. This court affirms. *Harte,* CA-2, 1/27/58.

Surviving annuitant must use deceased's zero basis for annuity cost (Old Law). A primary annuitant had recovered tax-free his total annuity cost at the time of his death in 1947. The value of taxpayer-survivor's interest, which amounted to $78,000, was included in his gross estate. The court holds the beneficiary entitled to the survivor's interest must include all his annuity payments in gross income since his basis for the annuity is the same as the zero basis to the deceased. Under the express provisions of the 1939 Code as amended in 1951, Section 113(a)(5), which allows a stepped-up basis for property transmitted at death, applies to the basis of a survivor-annuitant's interest only where the decedent dies after 1/5/51. *Morschauser,* 29 TC No. 78.

Distribution of installment obligations by trust accelerates tax. Taxpayer-trust and others had conveyed property to a new corporation for stock and installment notes in, the court finds, a taxable transaction. The trust reported the gain on the sale on the installment method. At issue here is the question whether the subsequent distribution by the trust of the installment notes to the trust beneficiaries is a disposition which, under the Code, makes the deferred gain taxable to the trust then. The court holds it is. *Shannon,* 29 TC No. 80.

Life tenant not liable for capital gains. Taxpayers had a life tenancy in an estate with powers to invade the corpus. Some of the property was sold at a gain and they paid the capital gains tax, but now sue for refund. The court holds they are entitled to it. As life tenants only they are not liable for the tax and the court refuses to find that they were trustees for remaindermen. The court follows *Cooke,* 228 F.2d 667. *de Bonchamps,* DC Calif., 2/26/58.

Fiduciary may deduct real estate taxes on non-probate property. An executor or administrator may deduct real estate taxes paid by the estate on real property not subject to administration if (1) taxes were a charge against the real estate at the date of the decedent's death and (2) under local law he is required to make such payments. However, if he is not required to pay these taxes, but does so, then the payments are deductible if they are made on behalf of an income beneficiary. *Rev. Rul.* 58-69.

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NEW DEVELOPMENTS IN

Foreign aspects of taxation

EDITED BY SIDNEY I. ROBERTS, LL.B., CPA,
JOHN COSTELLOE, LL.B., AND JOHN WILCOX, LL.B.

New decision revives confusion on foreign tax credit when tax base differs

CERTAINLY IT IS FAIR TO STATE that the general objective of the foreign tax credit provision is the mitigation of the effects of double taxation. However, it is well recognized that the limitation on the foreign tax credit imposed by Section 904 could produce erratic results by reason of the fact that the factors in that formula, namely, taxable income from sources within the foreign country, and total taxable income, are computed in accordance with United States principles. Thus, if a taxpayer is taxed in a foreign country with respect to an item of income which under United States law is not from sources within that country, there will be no foreign tax credit (assuming he has no other foreign income), even though there is double taxation. Similarly, if a taxpayer has two classes of income from sources within a foreign country, only one of which is taxed in that country, a foreign tax credit will be allowable for the taxes so paid, even though the income taxed in the foreign country is exempt from United States tax and the income taxed in the United States is exempt from tax in the foreign country.

A recent Tax Court case, *Federated Mutual Implement and Hardware Insurance Company*, 29 TC No. 50 (summarized 8 JTAX 121), while it does not introduce any change in the law, may well serve as a basis for a resurrection of the question of whether the limitation on the foreign tax credit can be enlarged to preclude a credit in cases in which there is no double taxation of the same income.

Under a literal reading of the statute it appears to be unquestionable that a credit is allowable for foreign tax paid even though some income taxed here is exempt abroad and other income taxed abroad is exempt here. Indeed this principle does not appear ever to have been questioned in cases in which income from foreign sources is taxed here, but for some reason is not taxed abroad. Thus income which is taxable under our law and which is from foreign sources is includible in the numerator of the limiting fraction, whether or not actually taxed in the foreign country. [*GCM 22556*, 1941-1 Cum. Bull. 310.] However, the Commissioner has, at various times in the past, contended that no credit should be allowed for foreign taxes paid with respect to income which is not taxed in the United States.

In *Hubbard* (17 Fed. Supp. 93 (Ct. Cl. 1936), *cert. den.*, 300 U.S. 666), the Commissioner contended that a tax credit should not be allowed with respect to the portion of the foreign tax attributable to earned income from foreign sources which was exempt from tax in the United States. The court sustained the Commissioner on the ground that the statute did not contemplate a credit for foreign taxes in the absence of double taxation. Following this decision, the Commissioner ruled that the foreign tax with respect to long-term capital gain which was fully taxed abroad is eligible for the credit only to the extent that it related to the portion of such gain taken in account for United States purposes. (*GCM 21432*, 1939-2 Cum. Bull. 234.)

The Commissioner's attempt to press this principle met its first setback in the leading cases of *I. B. Dexter*, (47 BTA 285 *acq.* 1948-2 Cum. Bull. 1) and *Helvering v. Nell*, 139 F.2d 865. The Board of Tax Appeal's decisions in the *Dexter* and *Nell* cases were at first non-acquiesced by the Commissioner. (1942-2 Cum. Bull. 24.) However, following the affirmance of the Board of Tax Appeals by the 4th Circuit in the *Nell* case, the Commissioner receded from his position and ruled that his contention, although reasonable and consonant with the purpose of the statute was, nevertheless, not supported by the statutory language. (*GCM 25723*, 1948-2 Cum. Bull. 131).

In the Tax Court case of *L. Helena Wilson* (7 TC 1469), the court denied the right of a taxpayer to claim credit for a foreign tax which purported to tax a legacy as income. Although the court reached its decision on the grounds that the tax was not an income tax, it cited the *Hubbard* case with apparent approval.

In 1949, the Commissioner, apparently in the belief that he had conceded too much in *GCM 25723*, again changed his mind. He withdrew his acquiescence in the *Nell* case and reasserted the position he had taken earlier in *Hubbard*. (*GCM 26062*, 1949-2 Cum. Bull. 110).

This time, however, the Commissioner was limiting his position to a much narrower area. Although withdrawing his acquiescence in the *Nell* case, he continued to acquiesce in the *Dexter* case. The *Nell* case dealt with foreign income which was exempt from United States tax, whereas the *Dexter* case dealt with long-term capital gain fully taken into account for foreign tax purposes, but only partially taxed here.

Relying on the Tax Court's apparent approval of the *Hubbard* case in its decision in the *Wilson* case, the Commissioner attempted to draw a fine distinction between the *Dexter* and *Nell* cases on the grounds that the former case involved double taxation since the same item was taxed in two countries, although the amount of the tax base was not the same, whereas in the latter case there was no double taxation at all since the United States did not tax the item of income taxed by the foreign country.

The Tax Court apparently did not intend to create such a distinction, for when the Commissioner placed his position before the Tax Court in the case of *James H. Brace* (11 TCM 906), in a case involving excludible earned income, the court rejected the contention with the statement "Respondent's attempt to revive an extinct quesion must . . . produce nothing but futility." (p. 907)

The Commissioner then gave further proof of his flexibility by again changing his position and by reinstating *GCM 25723 (supra)*. (*Rev. Rul. 54-15*, 1954-1 Cum. Bull. 129.) The official position of the Commissioner now is that in computing the foreign tax credit he will not

attempt to impose any limitations other than those imposed by the statute.

Federated Mutual Implement and Hardware Insurance Company, it will be recalled, involved a United States insurance company doing business in Canada which was taxed in Canada on net premiums from insurance written in Canada, but taxed in the United States only on net investment income. The taxpayer argued that, in computing the foreign tax credit for Canadian income tax, it was entitled to use as the numerator of the limiting fraction provided for in Section 904 the income actually taxed in Canada. The Commissioner, on the other hand, contended that that numerator should be the taxpayer's investment income from Canadian sources. The court, in holding for the Commissioner, apparently reached the correct result. However, because of an unfortunate dictum, the court may have imparted some impetus to the resurrection of an ancient problem.

After announcing its decision, the court made the following statement:

"In doing so, we are again mindful of our decision in *L. Helena Wilson*, (7 TC 1469). It might be argued upon the basis of that case that petitioner would be entitled to no credit for the latter four years because during those years there was no double taxation of the same income. Because respondent has, nevertheless, stipulated certain credits for those years, we assume the Commissioner does not seriously contend that the petitioner is entitled to no credit for those years on the theory that there was no double taxation of the same income, although in Canada the only income taxed was net premiums, while in the United States . . . . the only income taxed was investment income."

The Commissioner clearly adhered to his announced position in the *Federated Mutual Implement and Hardware Insurance Company* case since he stipulated that the numerator of the limiting fraction was the taxpayer's Canadian investment income, even though the foreign tax was paid with respect to net premiums, an item not included in the United States tax base. However, in view of the prior vacillation on this issue by the Commissioner, the dictum of the court in the *Federated Mutual Implement and Hardware Insurance Company* case is disturbing. It seems that, in view of the past history on this question, the court should have been particularly careful not to inject any confusion.

The *Wilson* case clearly involved the question of whether the tax for which credit was sought constituted an income tax and therefore has nothing to do with the question under discussion. The Tax Court and its predecessor, the Board of Tax Appeals, had never espoused the Commissioner's restrictive views. Consequently, the reference to the *Wilson* case as possibly supporting the position that the taxpayer may not be entitled to any tax credit in the *Federated Mutual Implement and Hardware Insurance Company* case clearly appears to be the result of confusion on the part of the court.

We can only hope that this dictum will not lead the Commissioner to believe that there is a change in the judicial climate which warrants his reassertion of a position which has been consistently rebuffed in the past. ☆

Final regulations on "substance of sale" show IRS shift on foreign sales

WHAT IS THE significance of the changes between the final regulations and the proposed regulations relating to the place of sale in determining the source of income? We reported here in March (8 JTAX 3, 172) some comments from the National Foreign Trade Convention recently to the effect that the final regulations had some defects not in the proposed ones and that inclusion in the final regulations of the "sustance of the sale" rule for tax-avoidance cases was regretted. This evoked a note from James McCarthy, Tax Counsel for General Electric Company, who wrote us that, as he sees it, the final regulations were actually an improvement over the proposed and that the Treasury deserves commendation for the changes.

"The proposed regulations," Mr. McCarthy says, "*did* contain the 'substance of the sale' rule; furthermore they stated that this rule would 'ordinarily' apply.

"This defect in the proposed regulations can best be understood by reference to the history behind them. From 1916 until 1930, the IRS followed the rule that the place of title passage determined the source of income derived from selling personal property. In 1930, the Service adopted a different rule: 'The essential character of the transaction—the contract of sale—is the decisive factor in determining the place of sale for the purpose of determining the source of income,' and 'for the purpose of determining the place of sale as far as this is decisive of the source of income, *"the substance of the sale is the agreement to sell"*.'" [italics supplied]. (GCM 8594, 1930-2 CB 354, 358.)

For the next 17 years, says Mr. McCarthy, the IRS attempted to apply that rule, but the Board of Tax Appeals and the courts refused to follow it and adhered to the title-passage rule. *See East Coast Oil Company, S.A.*, 31 BTA 558, *aff'd.* 85 F.2d 322 (CA 5, 1936), *cert. den.* 299 U.S. 608; *Ronrico Corporation*, 44 BTA 1130; and *Exolon Company*, 45 BTA 844. Finally in 1947 the Service issued G.C.M. 25131, 1947-2 CB 85, which again adopted the title-passage rule as the *general* rule, but provided that, *in tax avoidance cases*, "all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred."

Note in passing the two different meanings ascribed to the term "substance of the sale." In the 1930 ruling it was the agreement to sell; in the 1947 ruling the agreement to sell was only one factor to be considered. It is doubtful whether the term has any precise meaning, but it is clear that both of the above quotations stated a rule different from the title-passage rule.

Nine years later came the proposed regulations, which read:

"Section 1.861-7(c). *Country in which sold.* For the purposes of section 861 to 864, inclusive, sale of personal property shall be deemed to have occurred at the time when, and the place where, the rights, title, and interests of the seller in the property are transferred to the buyer. Generally, the time and place of the transfer depend upon the intention of the parties. For the purpose of ascertaining this intention, consideration shall be given to all of the circumstances of the sale, including the terms of the contract, the usages of the trade, and the conduct of the parties. Ordinarily, the

sale shall be deemed to have been consummated at the place where the substance of the sale occurred. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership."

This said that (1) the sale shall be deemed to occur at the place where title passes, and (2) "Ordinarily, the sale shall be deemed to have been consummated at the place where the substance of the sale occurred." The two-fold defect of the proposed regulations is now plain: first, it stated both the title-passage rule and the substance-of-sale rule as if they were not two different rules, and second, it stated that the substance-of-sale rule will "ordinarily" apply. The latter would have been an unintended repudiation of the 1947 ruling and the court cases, which state that "ordinarily" the title-passage rule applies and that the substance-of-sale rule is the exception.

In correcting these defects, the Treasury first deleted from the proposed regulations the second and third sentences, which were simply a restatement of the law of sales and therefore unnecessary, and then demoted the "substance of the sale" rule to the subordinate position it has held since 1947.

Although I sympathize with an idealistic aversion to the inclusion in the final regulations of the tax-avoidance exception which is dependent upon the motives of the taxpayer, there is no evidence that the Commissioner has applied it arbitrarily since he announced it in 1947. In any event, Section 1.861-7(c) finally gives the title-passage rule the dignity of a regulation, which should effectively foreclose the possibility that the ancient controversy will ever be reopened. In my opinion, therefore, it represents an improvement over both GCM 25131 and the proposed regulations. ☆

New decisions

Nonresident alien trading through attorneys-in-fact not "engaged" in trade or business [*Acquiescence*]. A nonresident alien who is engaged in trade or business within the U. S. is taxable on U. S. income. However, the Code provides that "trade or business" does not include transactions through a resident broker in marketable securities. Taxpayer, a nonresident alien with assets of over $2 million in the U. S., executed a power of attorney to two New York lawyers. During the taxable year they purchased and sold securities and made one sale of commodity futures on behalf of taxpayer. The lawyers also acted as officers and directors of taxpayer's two U. S. corporations which owned citrus groves in Florida. The court concludes taxpayer's activities in connection with the citrus groves did not amount to business here; the securities transactions were specifically exempt. Accordingly, capital gains on his security and commodity transactions were not subject to U. S. tax. *Neuman de Vegvar*, 28 TC 1055, *acq.*, 1958-7.

"Contested tax" doctrine not applicable to credit for foreign taxes. A foreign tax is to be accrued for the purpose of the foreign tax credit even though liability therefor is disputed and cannot be reasonably fixed in the year in which the foreign tax is due. The "contested tax" doctrine (which denies an accrual-basis taxpayer a deduction for a contested tax liability) does not apply in such cases since the purpose of the credit is to avoid double taxation on the specific income from foreign sources when earned. The accrual, however, cannot be made until the contested liability is finally determined. At that time it will relate back to the taxable year for which the foreign tax is in dispute. This ruling will not be given retroactive effect adverse to taxpayers for taxable years ending prior to February 24, 1958. *Rev. Rul.* 58-55.

Winner's purse received here by French racing stable tax exempt by treaty. A non-resident alien individual who operates a racing stable in France and enters a horse in a U. S. race is considered as engaged in a business within the U. S. Winnings would be subject to tax unless exempt by treaty provisions. Art. 3 of the U. S.-French treaty does exempt such winnings as commercial profits of a "French enterprise" not allocable to any permanent establishment in the U. S. *Rev. Rul.* 58-63.

Dividends, interest, not business income to qualify for WHTC deduction. An affiliated group may file a consolidated return and any Western Hemisphere Trade Corporation included may be allowed the special deduction. However, those members of the group which operate in the Western Hemisphere outside the U. S., but have gross income from dividends, interest, and capital gains only, are not Western Hemisphere Trade Corporations. Income of this type is not from trade or business, a necessity for qualification. In computing the limitation on the foreign tax credit, computed in terms of tax on income from sources within and without the U. S., the income of each WHTC should be allocated to sources within and without the U. S., and expenses and deductions (including the special WHTC deduction) properly allocated. *Rev. Rul.* 58-56.

Aliens not required to get certificate of compliance when passing through U. S. An alien who is in transit through the U. S., stays less than five days, and has no taxable income need not get a certificate of compliance. *Rev. Rul.*, 58-7.

New decisions involving exempt institutions

Religious community engaged in commerce not charitable. Certain religious communities, run on a communal basis, engage in such commercial enterprises as farming and manufacture. Profits from these activities, as well as contributions, are placed in a common treasury, from which funds are withdrawn for the support of the members and their families. The Service rules that contributions to or for the use of a communal religious organization, which engages as well in the operation of a commercial enterprise, the proceeds of which must necessarily inure to the benefit of its members, is not deductible as a charitable bequest or contribution under the estate or gift sections of the Code. *Rev. Rul.* 57-574.

Contributions to individual publisher of church directory nondeductible. No deduction is allowed for contributions to an individual to finance the publication and free distribution of a church directory to local hotels, motels, and tourist homes because the donee is not a corporation, trust, or foundation. *Rev. Rul.* 57-525.

Contribution to bank library not deductible. A donation of books to a library open to the general public, but maintained by a banking institution on its own premises, is not deductible as a charitable contribution. Despite the intended use of the contribution, it does not qualify unless the recipient meets the statutory tests. *Rev. Rul.* 57-600.

NEW DEVELOPMENTS IN

Fraud & negligence

EDITED BY HARRY GRAHAM BALTER, LL.B.

Omissions from income fraudulent. Taxpayer's net worth statement revealed a substantial increase in his asset position which greatly exceeded the total gross income reported. It was shown that he obtained funds from a controlled corporation through the use of fictitious invoices issued in the names of non-existing companies covering materials, services, and expenses that likewise were fictitious. The court upholds the Commissioner's assessments on the basis of unreported income, and charges taxpayer with a fraudulent intent to evade tax. *James,* TCM 1957-198.

Conviction for evading tax on black market sugar upheld. The three who appeal from their conviction of evasion of income tax on the profits realized by dealing in black market sugar during the war are Giglio and Livorsi, the principals, and Lawn, an attorney, who was an employee of many of their enterprises. Lawn had been the chief of the Criminal Division of the New Jersey United States Attorney's office. The main point at issue was whether it was error for the lower court to deny their request that the records of the indicating Grand Jury be examined to see whether it had used certain documents which, it had been decided, a prior Grand Jury obtained in violation of their rights—the violation being that Lawn and another employee were directed to bring corporate records and to testify without being warned of their constitutional rights, though tax investigations were in progress and criminal proceedings had begun. The Supreme Court finds no error. *Lawn,* Sp Ct., 1/13/58.

Klein's conviction for conspiracy upheld; used multiple foreign corporations [*Certiorari denied*]. Defendants used a syndicate of foreign and domestic corporations so that profits on sales of whiskey in the U. S. during World War II accumulated free of U. S. tax in a foreign corporation, which was subsequently liquidated at a capital gain to the American stockholder. The district court held that the question of whether these corporations were sham or carried on some business activity involved a complex issue of law and was not for the jury to decide. It thereafter dismissed four counts charging evasion. Where, however, certain payments made by one of the corporations were given inconsistent treatment by the corporation and by the various defendants, the court finds a question for the jury on the existence or nonexistence of a conspiracy to defraud the U. S. by impeding and obstructing the functions of the Treasury Department. The jury found them guilty. The Second Circuit affirmed. While the conspiracy charge was broadly stated, and the prosecution and the court carefully avoided adopting any one of the various theories of the nature of the payments, the difficulties arose at bottom out of the complexity of the facts, as deliberately arranged by the defendants. Of this, they cannot now complain. The judge's charge to the jury was also, the Second Circuit stated, very skillful. "The ultimate fact was simple and the judge succeeded in keeping it from being concealed by the multitudinous details . . . In summary we find that defendants had a rigorously fair trial. . . . The convictions were amply justified. Here tremendous American profits were skillfully concealed from the collector's eyes until they were uncovered by this patient investigation and trial. The result should be salutary." *Klein, cert den.,* 1/13/58.

Can't suppress evidence under Fifth Amendment prior to indictment [*Certiorari denied*]. Taxpayer alleged that the district attorney was about to ask for his indictment and he sought a court order to suppress evidence—his books and records, delivered to Special Agents after, he claimed, the collector had assured him he did not consider the case appropriate for prosecution and that taxpayer would be safe in turning over the records. The Sixth Circuit reviewed cases in other circuits which have suppressed evidence in the preindictment stage when violation of the Fifth Amendment (self-incrimination) was involved. Rules of Criminal procedure allow suppression when the Fourth Amendment (unreasonable search) is involved. The Sixth Circuit concluded that if preindictment suppression should be allowed for the Fifth Amendment, it should come about by amendment of the rules—not decisions. However, lest it be in error on this point, Sixth Circuit considered the case on its merits. The district court had found as a fact that there was no misrepresentation or trickery and that the books were handed over voluntarily. The Sixth Circuit affirmed. *Biggs, cert. den.,* 1/13/58.

Government can show alleged disclosure was part of "tax fix." Taxpayers had been convicted of criminal tax evasion in connection with the failure of their corporation to report black market sales. However, the Court of Appeals had reversed on the ground that it was improper to admit evidence made available by taxpayers relying on the Treasury policy (in force at that time) of not seeking criminal penalties if voluntary disclosure was made. Now the Government asks a new trial because it has evidence that there had been no disclosure prior to the time investigation was started and that the story of the earlier discussions with the Bureau of Internal Revenue was all part of an attempt to "fix" the case. The Supreme Court agrees and sends the case back to the district court for a new trial. It cannot make a decision based on a record on which there has been cast a grave suspicion that it is fraudulent. Three judges dissent. There have been many cases holding that a disclosure (a waiver of rights against self-incrimination) cannot be used as evidence if made under a promise of immunity. They think the Court should specifically consider the question whether this rule is abrogated if the suspect is not acting in good faith. *Shotwell Mfg. Co.,* Sp. Ct., 12/16/57.

Returns signed for husband by wife start statute of limitations [*Acquiescence*]. Taxpayer, who had been a bus driver and had had little education, began his own bus line. His wife (who divorced him in 1948) kept all the records (nothing more than single entry listings) and they were very inaccurate.

He filed no return for 1940; for 1941-1945 she prepared a separate return for him as the business operator and signed his name to it. The court finds that she had authority to sign his name and these returns started the statute of limitations for 1941-1945 since, it finds, there was no fraud involved. For 1940 the deficiency is proper, but only negligence penalties, not fraud, are assessed. Judge Murdock dissents. He would follow the previous position of the Tax Court that the Regulation requiring a competent taxpayer to sign his own return is valid despite the recent decision by the Fifth Circuit (Miller 237 F.2d 830) that the Code permits signing by an authorized agent. The importance of forcing taxpayers to take responsibility for their returns is shown by cases like this where fraud is charged. In any event, he concludes this taxpayer was not so stupid as to be unaware of consistent understatement—his income as shown by the net worth computations totalled some $209,000 over the five years and only $45,000 was reported. *Booner,* 28 TC 817. *Acq. on fraud issue only,* IRB 1958-7.

Jury upholds taxpayer's valuation and finds no negligence in it. Taxpayer received stock in a closely held corporation in payment of his brother's note. The taxpayer valued the stock at $52,425 and so reported it on his return. The Commissioner valued the stock at $119,000 and assessed a negligence penalty for failure to report it at the $119,000 value. The jury finds the stock worth $57,425 and finds taxpayer not negligent. *Hamilton,* DC Ala., 9/26/57.

Reliance on accountant does not excuse failure to file estimated tax. Taxpayer relied on the advice of a public accountant to the effect that he didn't think that a declaration was necessary if taxpayer filed his return by January 15 of the following year, and that the government would probably not assess penalties for failure to file such declaration. The court holds this reliance is not reasonable cause for failure to file and upholds the penalty. The court doesn't discuss the accountant's qualifications; it notes that the advice was based, not on the statutory requirements, but the guess that no penalty would be asserted. *Hickman,* 29 TC No. 94.

Fraud not proved by showing only net worth increase and total tax paid. It was too late for the Commissioner to assess tax for the years here in issue unless he could prove fraud. The Commissioner was able to compute taxpayer's net-worth increase for these years and the taxpayer agreed it was correct. However, the IRS had already destroyed the returns for those years and could show only the net amount of tax paid. The majority held that the Commissioner had not met the burden of proving fraud—there is no proof of the amount of income reported. Three judges dissent—the agreed net worth increase computation gives enough data on expenses and deductions to make it clear that the tax reported was arrived at by fraudulently omitting income. Moreover the tax is on net income and the Commissioner meets the burden by showing a low net reported together with other facts of record (lack of books, etc.) which support the inference of fraud. *Rubinstein,* 29 TC No. 93.

Taxpayer can't object to summons to third parties in re his taxes. The IRS issued summonses to certain individuals and corporations ordering them to produce records of their transactions with taxpayer. Taxpayer sought to object to these summonses. The court holds that taxpayer cannot object. Only the person summoned can object to a summons. *Albachten,* DC Calif., 10/21/57.

Commissioner's answer must detail net-worth statements relied on to prove fraud. The Tax Court ordered the Commissioner's answer to taxpayer's petition stricken from the record for failing to give sufficient details of facts relied on by him to prove fraud. The deficiencies involved were barred unless they were fraudulent; consequently, the entire burden of proof was on the Commissioner. The Commissioner's original answer merely repeated the figures in the deficiency notice and gave no explanation. Upon order, he submitted a very summary net-worth statement. When he was ordered to supply more detail, he merely resubmitted the statement. The Tax Court ordered the amended answer stricken; it pointed out, for example, that increase in real estate must have represented specific parcels and that taxpayer is entitled to facts of this kind. The Commissioner argued that to give more detail would provide information the taxpayer could not otherwise obtain for use in a threatened criminal action. This court affirms the Tax Court action as being within its discretion and supported by its rules requiring a full stipulation of facts. *Licaroti,* CA-6, 2/14/58.

Contempt proceeding ordered to determine if records should be produced. The sole stockholder of a Panamanian corporation seeks to vacate an order compelling him to produce the corporate records. In support of his motion he presents an affidavit that the books are in the custody of the corporation's president in Panama, who refuses to release them, and that this refusal is supported by Panamanian law. In this state of the record, the court is unable to determine the good faith of this affidavit and orders that the matter be brought up on contempt proceedings. *Reicher,* DC N. Y., 2/25/58.

Proof of likely source of unreported income not necessary to sustain net worth conviction. Taxpayer, a policeman, was convicted of criminal tax evasion without proof of a possible source for the unreported income. The First Circuit reversed on the grounds that *Holland,* 348 U.S. 121, required that the Government prove that there was a likely source of unreported income. The Supreme Court says that proof of a likely source is not necessary in every case. The Government need not prove a likely source if it can negate the possible sources of non-taxable income. *Masser,* Sp. Ct., 3/3/58.

Commissioner's net worth determinations upheld. In computing taxpayer's net worth, the Commissioner arrived at the amount of loans due him from notes and trust deeds recorded by taxpayer in the county recorder's office. This court holds this is sufficiently substantiated evidence to support the Tax Court's net worth determination and fraud penalties. *Shaw,* CA-6, 2/19/58.

Doctor's failure to report substantial income was fraud [*Certiorari denied*]. Deceased taxpayer, a doctor, omitted over $47,000 of income for the year 1947 (he reported about $24,000). The executor argued that the error was due, not to intentional fraud, but to negligence of employees in his office. The Sixth Circuit affirmed the Tax Court, holding that a doctor conducting an individual practice must have been aware of his income and that the gross understatement must have been apparent to him. *Haskins Estate (Harber Ex'r), cert den.,* 3/3/58.

TAX STRATEGY, NEWS OF THE REVENUE SERVICE

Effective tax procedures

EDITED BY MARTIN M. LORE, LL.B., CPA

Net worth method and fraud penalty sustained. The fraud penalty was assessed against taxpayer for the years 1942-1945. Taxpayer sold autos, boats, machinery and engaged in other activities including stock market operations. He kept no records except for some invoices and sales slips. The Tax Court held that the Commissioner was justified in using the net worth method and sustained the fraud penalty. Because of the finding of fraud, the statute of limitations had not run on any of the years 1942-1945. For 1946 and 1947 income was recomputed from taxpayer's fragmentary records and only the negligence penalty was asserted and sustained. This court affirms. *Lusk,* CA-7, 10/14/57.

Acceptance of amended return permits mitigation of limitation on another year. Taxpayer did not claim certain allowable deductions in 1951 but did claim them on his 1952 return. Subsequently he filed an amended 1952 return, omitting these items, and paid the tax. The IRS rules that the acceptance of the amended 1952 return by the Commissioner is to be treated as a deficiency. Thus although 1951 is closed under the general rule, the inconsistent 1951-1952 treatment can be corrected under the mitigation-of-limitations rule if a statutory "determination" is made while 1952 is an open year. *Rev. Rul.* 58-12.

Mitigation of limitations applicable despite pyramiding of deductions. Taxpayer had been following the practice of deducting vacation pay in the year it paid it, though as an accrual basis taxpayer it ought to have accrued it in the prior year. In the year 1953 it deducted two items of vacation pay—that paid in 1953 which properly accrued in 1952 and that properly accruable in 1953, payable in 1954. The IRS rules that because correction of the 1952 return to include the additional deduction of 1953 accrued vacation pay was not barred at the time the 1953 return was filed, mitigation of the statute of limitations is permitted due to the inconsistent position taken on the 1953 return. The IRS notes that this will result in a pyramiding of two vacation pay deductions in 1952 but holds that this result is required by the statute. *Rev. Rul.* 58-24.

Interest allowed on overassessment without offset against compromise liability. Mim. 1819 was an offer of settlement to all casualty insurance companies based on certain issues being litigated with the IRS. The offer of settlement was that the amount of tax under the IRS contentions as to these issues would be accepted as both the tax deficiency and the interest thereon. Taxpayer accepted this offer. It also had overassessments for some of the years on other grounds. This court holds the overassessments bear interest to date of payment. There is to be no offset on account of the compromised deficiencies, that settlement had no effect on the overassessments and the interest on them. *St. Paul Fire and Marine Ins. Co.,* DC Minn., 1/6/58.

Conscientious objector can't get declaratory judgment of tax status. Taxpayer refused to pay half his tax on the ground he was conscientiously opposed to war and could not support that part of the Federal budget devoted to war activities. The tax was collected by distraint, and he brought this suit for a declaration of his rights. Since the Federal Declaratory Judgments Act specifically prohibits such actions in tax matters, the suit was properly dismissed. *Mayer,* CA-9, 1/15/58.

Adding carryback not mere amendment; it is new untimely claim. Taxpayer filed timely claims for excess profits tax relief (Section 722) for 1943 and 1944 but made no reference to an unused excess profits tax credit carryback from 1945. It later amended its claim to request the carryback credit. The court holds the amendment ineffective, since it was filed after the statute of limitations applicable to the year of the unused credit had barred the claims. *Royal Frocks, Inc.,* 29 TC No. 86. To the same effect, *Dale Distributing Co., Inc.,* 29 TC No. 87.

Costs exceeded sales; omissions necessarily over 25% of gross. Use of the net worth method to reconstruct the income of taxpayer, a nursery operator, whose books and records were destroyed prior to the examination, is sustained with some slight adjustments in the Commissioner's computation. Although the notice of deficiency was dated after three years (but before five years) from the date of filing of the returns, it is held timely because the omitted gross income as computed on the net worth schedules exceeded 25% of the gross income stated on the returns, as the returns showed no gross income (taxpayer's cost of goods sold exceeded his sales). *Bynum,* TCM 1958-19.

Lack of notice of jeopardy assessment no bar to Government counterclaim. Taxpayers overpaid their personal income taxes and are now suing for a refund. The Government counterclaims for a failure to pay withheld payroll taxes of their dissolved corporation. [Apparently taxpayer-husband conceded liability as an officer for the corporate payroll tax.—*Ed.*] The failure of the Government to give taxpayers notice of the jeopardy assessment against them is no bar to the counterclaim, as the statute of limitations has not run. Further, the court notes, suit may be begun without assessment at any time for taxes wilfully evaded and taxpayers here acted wilfully. *St. John,* DC Mo., 12/30/57.

Must include deductions in computing unreported gross in net worth case [*Acquiescence*]. The burden of proof is on the Commissioner to show that the five-year statute applies because unreported gross income was 25% of reported gross. The court holds that when the Commissioner's case is based on net worth computations he must show that the omitted net income did not arise from overstated deductions. Here if taxpayer's claimed expenses were all improper, the 25% test would not be met and in the absence of proof of their propriety by the Commissioner the court holds the year closed. *Courtney,* 28 TC 658, *acq.* IRB 1957-49.

Injunction to restrain collection of evaded taxes denied. Taxpayers correctly reported their 1947 income and deduc-

tions but claimed that they had made a $35,000 payment on account. They actually made much smaller payments on account. Taxpayers signed waivers which extend the assessment period until 1955. In 1954 taxpayers were assessed the unpaid balance. Taxpayers' request for injunctive relief against the assessment is denied for three reasons: (1) the waivers extended the statute of limitations on collection of the amount due as well as any deficiency in the reported income; (2) there is no statute of limitations for tax fraud; (3) taxpayers have not shown that this constitutes a special-circumstances case so as to permit an injunction against the collection of taxes. *Goldsmith,* DC N. Y., 1/2/58.

Tax Court has no jurisdiction over year not in deficiency notice. For lack of jurisdiction, the Tax Court refuses to consider a claim for refund of 1948 tax overpayment; the deficiency notice covered only the years 1950 and 1951. *Barnhart,* TCM 1958-11.

Title properly set aside as fraudulently conveyed though no transferee assessment was made [*Certiorari denied*]. The district court found that transfer of title to certain real estate to taxpayer-wife was a fraudulent conveyance, in that it rendered taxpayer-husband insolvent and unable to pay tax deficiencies and fraud penalties. The wife argued that this was improper because the tax had never been assessed against her as transferee. The Eighth Circuit held that the lower court action was proper. It is true that the tax could not be collected from her as transferee without proper assessment, but such an assessment is not necessary when the action taken by the Commissioner is the recovery of property fraudulently conveyed, not collection of tax. *Payne, cert. den.* 1/13/58.

Taxpayer cannot refuse to pay taxes because revenue used for war purposes. Taxpayer sued for a refund of two-thirds of his 1949 income taxes because this portion of the federal revenue had been appropriated by Congress for the preparation and the waging of aggressive war. The district court granted the government's motion for judgment on the pleading on the grounds that it does not have the authority to review the foreign policy or military program of the government. Congress has the right to levy taxes and to appropriate revenues for the common defense and general welfare of the country, and to provide for and maintain an army and navy. The courts have no power of review in these areas. This court affirms. *Farmer,* CA-6, 2/12/58.

Short business and pleasure trips from district don't toll statute. The six-year statute of limitations on criminal prosecutions would bar this proceeding unless the time was extended by 137 days taxpayers were outside the judicial district on business and pleasure trips (the longest was for 27 days). The court reviews the conflicting and confusing case law on absence from the judicial district and concludes that occasional and sporadic absences do not extend the limitation period; the extension is allowable only if the absences indicate flight from justice or substantially impair the enforcement functions of the government. *Gross* DC Nev., 1/31/58.

Overpayment on joint return may be credited to individual tax liability. Taxpayers overpaid their income tax liability when they filed their joint return. However, taxpayer-husband owed payroll taxes withheld but not paid to the Government. The court sustains the Government's offset of the joint income tax overpayment against the payroll tax liability of the husband. There was no showing that the wife had any income. *St. John,* DC Mo., 12/30/57.

Case remanded to Tax Court for second time. This is the second appeal of this case to the Fourth Circuit. Taxpayer, a physician, had not reported income from illegal operations. The Commissioner estimated his income on the basis of morphine purchased and charged him with $192,000 for 1948 and $96,000 for 1949. The Tax Court (TCM 1955-238) reduced this to $115,000 and $55,000. On appeal, the Fourth Circuit vacated and remanded to find the facts on which this holding was based. The Tax Court judge who made the earlier decision having retired and neither the Commissioner nor the taxpayer filing new evidence, the Tax Court then repeated the finding of drugs purchased. Since this finding does not support the income determination of the Tax Court, the Fourth Circuit again remands for a new trial. *MacCrowe Estate,* CA-4, 2/12/58.

Corporation must bring refund suit in state of incorporation. Taxpayer was incorporated in Delaware; however, its only place of business was in Nebraska, where its officers and records were and its returns were filed, and where it dealt with the IRS. It brought this suit in Nebraska for refund of tax. Reviewing the conflicting cases on the proper district for corporate suit, and conceding the practical difficulty to the taxpayer, the court concludes that taxpayer must sue in Delaware. It has long been established that a corporation's residence for this purpose is the state of incorporation and, despite holdings in some courts to the contrary, the court finds that the somewhat ambiguous language of the Judicial Code makes the place of business a residence for venue purposes only when the corporation is a defendant, not when it is plaintiff, as it is here. *Nebraska-Iowa Bridge Corporation,* DC Neb., 1/21/58.

Deficiency notice proper though sent to wrong address. The deficiency notice was sent to taxpayer in Shanghai, China, its last known address. It had, however, left China and did not receive the notice. The court holds that taxpayer may not enjoin the collection of tax; it was given the statutory notice. The Code forbids the issuance of an injunction to restrain collection of tax with one exception—collection may be restrained if the Commissioner fails to give taxpayer notice. Here the notice was given even though it was not received. *Shanghai Realty Development Corp.,* DC D. C., 1/29/58.

Suit after part payment of assessment does not bar suit after payment of rest. Taxpayer paid part of additional assessments for 1943-1946 and brought suits for all years. [The court notes that the government did not raise the issue whether the full payment of the assessment should have been required prior to suit.—*Ed.*] At issue was the validity of a family partnership. The district court's decision was against taxpayer. He appealed all years, except 1945. The reason taxpayer did not appeal 1945 was that taxpayer was conceding some other issues for that year and claimed no net overpayment. Taxpayer won on the appeal; he then paid the rest of the 1945 assessment and sued for its refund. The District Court held that, the year 1945 having been litigated once, without appeal, the doctrine of res judicata prevented a collateral attack on the prior judgment by this suit. This Court reverses. The issue in the first suit was

whether the payments made as of the date of the suit were an overpayment of taxes. It is not a bar to this suit, in which the question is whether the subsequent payments are an overpayment of taxes. *Snyder,* CA-9, 1/27/58.

Statute of limitations no bar to assessment where inconsistent position taken. Taxpayer reported in his 1944 return $42,000 as royalties from publication of a book which he treated as long-term capital gain. Actually, he received $12,000 of this sum in 1944 and the balance in 1945. In 1948 taxpayer filed a refund claim on the ground that only $12,000, the amount actually received in 1944, was taxable that year. On the other hand, the Commissioner assessed a deficiency on the basis that the $42,000 reported as received in 1944 was taxable as ordinary income. The Tax Court sustained the Commissioner on this point although it agreed with taxpayer that only the $12,000 received was taxable in 1944. This decision was affirmed by the circuit court and became final on October 8, 1956, upon denial of taxpayer's petition for certiorari. Thus it was determined that 1944 did not include the $30,000 also excluded from taxpayer's 1945 return. In December 1956 the Commissioner assessed a deficiency attempting to tax as 1945 income the $30,000 royalties received in 1945 which were not reported in that year. This assessment would be too late unless it came within the special rule covering inconsistent positions. The court holds it does. The position maintained by taxpayer in his 1944 refund claim, which was adopted in a final court determination in 1956, was inconsistent with the position originally taken in filing his 1945 return. *Cory,* 29 TC No. 96.

Government merely filed claim in probate court, but did not sue; suit now barred. The statute of limitations is six years for bringing a suit to collect taxes after assessment. The government's only action during the six-year period was to file a proof of claim against the deceased taxpayer's estate in the probate court. The jurisdiction of the probate court in Massachusetts is limited, and the only effect of the government's proof of claim was to put the executors on notice. A suit for the tax would have to be commenced in another court. The present suit to collect is dismissed as barred by the statute; the government "was waiting for a train that did not run." *Saxe,* DC Mass., 1/24/58.

Extending time to assess corporation extends it for transferees. This court affirms the district court holding that the transfer of all a corporation's assets, subject to its liabilities, to its stockholders (who carried on the business as a partnership) rendered the corporation insolvent and therefore the stockholders are liable as transferees for prior-year corporate income taxes. Waivers, signed for the corporation, extending the time for assessment of tax, extend the time for asserting tax against the transferees, since the time for assessing the transferees is, under the Code, one year after expiration of time for the taxpayer. *Dardi,* CA-9, 2/21/58.

Can't sue unless refund has been claimed from Commission. The IRC provides that no suit for refund shall be brought before six months from the date of filing a refund claim with the Commissioner. The taxpayers here brought such a suit and the Court dismissed it without prejudice to their right to bring a new suit after the six months has expired. *Handshoe,* DC Md., 9/23/57.

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